The Norton Tax Bulletin

Richard E. Norton, E.A., Tax Resolution Specialist
513 North Florence Street, Burbank, California 91505
(818) 842-5927 Fax: (818) 845-6031 E-mail: dick@dicknorton.com

Issue: 2021.3

March 19, 2021

Delay in 2020 filing; More information on virtual currencies; Tax Tips; Home Office Deduction; Child Care Credit Changes for 2021

Dear clients, family and friends,

It has been a crazy tax season so far. But fortunately, *better late than never*, the IRS (*and then CA – and some other states*) opted to extend the filing and payment deadline from April 15 to May 17, 2021. This means that so long as your returns are postmarked or submitted electronically by midnight May 17th, they will be deemed timely. Unlike last year, however, the due date for the first quarter estimated tax payment **remains April 15th**.

Virtual Currenies

The IRS recently issued new cryptocurrency guidance and is hot on your trail if you bought and sold cryptocurrency and did not report it on your past tax return. There has been an explosion when it comes to taxpayers investing in these currencies (*such as Bitcoin).* Here are the tax basics. You will treat cryptocurrency as property (*not as money*) for tax purposes. Here are some examples to help you understand the concepts.

Cryptocurrency is a capital asset (*provided you are not in the business of being a trader*). Therefore,

- you pay tax on any gain at reduced rates if held for more than one year, and
- losses are subject to capital loss limitation rules.

If you receive bitcoin in exchange for your services, then your income is the fair market value of the bitcoin received. Your basis in the bitcoin received is its fair market value at the time of receipt plus any transaction fees incurred. The basis is important as it serves as the measure of any gain or loss upon the ultimate disposition of the specific virtual currency.

To illustrate, you are a house painter and you paint a customer's home. You agree to accept Bitcoin for the work you perform. The customer gives you $10,000 in Bitcoin (*its value on the date of payment*). Your gross income that you must report on your return for that job is the fair market value of that Bitcoin ($10,000) in this example. Those Bitcoins now have a basis of $10,000 *(the amount you reported as income*). If you immediately sell the Bitcoin for $10,000 in cash, you have neither a gain nor a loss on that sale. By contrast, if you opt to wait for 6 months and then sell that Bitcoin for $11,000, then you have a short-term gain (*you held it for one year or less*) to report of $1,000 – the difference between what you received in cash and your basis for that Bitcoin.

If you receive bitcoin in exchange for your property, then your gain or loss is the fair market value of the bitcoin received less the adjusted basis of your property given up. Your basis in the bitcoin is its fair market value at the time of receipt plus any transaction fees incurred.

As an example, you have a vacant piece of land in the mountains that you sell to a buyer who gives you $20,000 in Bitcoin (*its current fair market value*). You will report the same on your return reflecting the $20,000 in Bitcoin as your sales price, subtract your basis in that piece of land, and either have a capital gain or loss on that transaction. If you immediately sell the Bitcoin and receive $20,000 in cash, then you have no gain or loss on the sale of the Bitcoin. However, if you wait for *more than a year* and then sell it for, say, $25,000, then you will report a long term (*held for more than a year*) capital gain of $5,000 *($25,000 received minus the $20,000 basis in that Bitcoin).*

If you give bitcoin in exchange for services, then the value (*or deduction if a business purpose*) of the expense is the fair market value of the bitcoin given. Also, the value of the services received less the adjusted basis of the bitcoin is a gain or loss to you. In effect, this transaction (giving up Bitcoin for services) can result in two different transactions that need to be reported.

This example is a bit more complex. Let's say you own a rental apartment building. A tenant moves out and you hire a painter to paint the inside walls of the vacant apartment. You agree on a price of $2500 for the work. When the job is completed, you give the painter $2,500 (*at the current fair market value*) of Bitcoin. This will result in two (2) transactions.

First, the expense you get to deduct on your rental schedule is $2,500 – the fair market value of the Bitcoin *($2,500 in this example).* Second, depending upon your basis in the Bitcoin given to the painter – *as well as how long you have owned it* – you may have to report either a short-term or long-term capital gain or loss. For instance, if the Bitcoin you gave to the painter has a basis of $2,000 (*what you paid for it*) and you have owned it for, say, 9 months, you will have a short-term capital gain of $500 *($2,500 minus $2,000*). If you owned it for two years and its basis was $3,000 (*meaning it lost value during the time you owned it*), then you would have a long-term capital loss to report.

If you give bitcoin in exchange for someone's property, then your gain or loss is the fair market value of the property you received less the adjusted basis of your bitcoin. OK, *how does this work?*

Let's assume you have Bitcoin that has a current fair market value of $20,000, but a basis to you of $15,000 (*meaning it increased in value during the time you owned it).* You see a piece of land in the mountains you want to buy for a future cabin. The sales price happens to be $20,000. The seller agrees to accept your $20,000 of Bitcoin in exchange for the property. While the land you just bought has a fair market value of $20,000, your cost basis for a future sale is $15,000 – the basis you had in the Bitcoin you used to purchase that property. You will have to report a gain (*either short or long term depending upon how long you owned the Bitcoin*) of $5,000 – the difference between the fair market value of the property you just acquired and the basis of the Bitcoin given for that property.

Gifting virtual currency

Taxpayers who receive virtual currency as a gift will not have any immediate income tax consequences and may have the same basis and holding period as the donor. Gifts of virtual currency can be subject to gift tax and generation skipping tax if the value of the cryptocurrency is above the annual and lifetime exclusion amounts.

Tom gives $20,000 worth (*current fair market value*) of cryptocurrency, a virtual currency, to his sister Susie. She will need to know Tom's basis, his holding period, and the fair market value of the cryptocurrency at the time of the gift. Susie decides to hold onto the cryptocurrency as an investment.

Susie may use Tom's basis of $25,000 and his holding period of two years if she sells or exchanges of the cryptocurrency for a gain (profit). If, however, Susie sells the cryptocurrency one year later when it is worth $23,000, she will have no gain and no loss on the transaction since the fair market value at the time of the gift was LESS than what she sold it for. So, any sales price between $20,000 and $25,000 will not result in a gain or loss to Susie.

To illustrate this principle, if Susie sold the Bitcoin for $18,000, she would report a $2,000 loss *($18,000 received minus the fair market value of $20,000 at time she received the Bitcoin).* If she sold it for $27,000, she would report a $2,000 gain ($27,000 received minus Tom's basis of $25,000).

Tom will not have any *income tax* consequences associated with the gift to his sister. However, he may have gift tax reporting consequences because the amount of the gift is over the annual exclusion amount of $15,000. He will have to file a gift tax return (Form 709).

Forks

In the cryptocurrency world, a fork occurs when the digital register that logs transactions of a particular cryptocurrency diverges into a new digital register. There are two types of forks:

- one in which you do not get any new cryptocurrency, and
- one in which you get new cryptocurrency.

The IRS ruled that:

- a fork in which you don't get cryptocurrency is not a taxable event, and
- a fork in which you do receive new cryptocurrency is a taxable event and you'll recognize ordinary income equal to the fair market value of the new cryptocurrency received. Your basis in the new cryptocurrency will be the fair market value when received.

Example. You own J, a cryptocurrency. A fork occurs and you receive three units of K, a new cryptocurrency. At the time of the fork, K has a value of $20 per unit. You'll recognize $60 of ordinary income due to the fork.

Specific Identification

When selling property, you generally sell it on a first-in, first-out (FIFO) basis, unless you are eligible to use the *specific identification method*. You will want to use the specific identification method if you can because you can select the amount of gain or loss your sale will create. With FIFO, you have no choice.

To use the specific identification method, you'll have to either:

- document the specific unit's unique digital identifier, such as a private key, public key, and address, or
- keep records showing the transaction information for all units of a specific virtual currency, such as bitcoin, held in a single account, wallet, or address.

This information must show:

- the date and time you acquired each unit;

- your basis and the fair market value of each unit at the time you acquired it;
- the date and time you sold, exchanged, or otherwise disposed of each unit;
- the fair market value of each unit when you sold, exchanged, or disposed of it; and
- the amount of money or the value of property received for each unit.

Important – the IRS is really getting involved in this area as it believes millions of taxpayers are failing to report or accurately report their virtual currency transactions. This year (2020 return), every taxpayer must certify whether or not they were involved with virtual currencies during the year. Misleading the IRS in this area by inaccurately responding to the question can have serious consequences. So, be sure to let me (*or your preparer*) know if you have been involved in any way with virtual currencies.

If you opt to get involved in Bitcoin or other virtual currency trading, just be forewarned of the high level of recordkeeping that will be required, and the reporting obligations whenever you have transactions in the specific virtual currency you own.

Tax Tips

New Forgiveness Rules for Past, Current, and New PPP Money

Good news: the new Paycheck Protection Program (PPP) law enacted with the stimulus package adds dollars to your pocket if you have or had PPP money. Note that the PPP money comes to you in what appears to be a loan. We say "appears" because you typically pay back a loan.

Done right, however, the PPP loan is 100 percent forgiven. The word "loan" makes some businesses leery of this arrangement. Don't be. The PPP monetary arrangement is a true "have your cake and eat it too" deal. And this remarkable deal applies to your past PPP loan, the PPP loan you have outstanding, and the PPP loan you are about to get if you have not had one before. Here are the details:

Loan Proceeds Are Not Taxable

The COVID-19-related Tax Relief Act of 2020 reiterates that your PPP loan forgiveness amount is not taxable income to you.

Expenses Paid with Forgiven Loan Money Are Tax-Deductible

As you may remember, the IRS took the position that expenses paid with PPP loan forgiveness monies were not deductible. Lawmakers disagreed but were unable to get the IRS to change its position. The IRS essentially told lawmakers, "If you want the expenses paid with a PPP loan to be deductible, change the law." And that's precisely what lawmakers did.

The COVID-19-related Tax Relief Act of 2020 states that "no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income."

In plain English, the expenses paid with monies from a forgiven PPP loan are now tax-deductible, and this change goes back to March 27, 2020, the date the Coronavirus Aid, Relief, and Economic Security (CARES) Act was enacted.

Round 2: Additional Tax-Free PPP Money for You?

If you received an initial PPP loan, you can qualify for a second round (*called a "second draw")* of tax-free PPP money.

To qualify for the second-draw PPP money, you must

1. have 300 or fewer employees;
2. have suffered a 25 percent or greater loss in revenue during at least one quarter of 2020 when compared to 2019; and
3. have already used your original PPP money (or be planning to use it soon).

The mechanics of the second-draw PPP loan amount follow the rules that apply to the original (first-draw) PPP loan, with some modifications. The overall limits work as follows:

- The loans are capped at $2 million or less.
- If you are not a hotel or restaurant (NAICS code 72), you identify your average monthly payroll for either 2019 or the trailing 12 months and then multiply it by 2.5 to find your loan amount.
- If you are a hotel or restaurant, you multiply by 3.5.

During a period of your choice, beginning eight weeks from the origination date of the loan and ending 24 weeks after the origination date, you must use 60 percent or more of the monies for defined payroll in order to achieve 100 percent forgiveness.

Expenses that can qualify for forgiveness include the following:

- Payroll
- Rent
- Interest on mortgage obligations
- Utilities
- Operations expenditures
- Property damage
- Supplier costs
- Worker protection

And finally, keep these three thoughts in mind:

1. Act fast, because this money goes in a hurry.
2. The incoming PPP loan monies are tax-free.
3. Expenses paid with PPP loan monies that are forgiven are tax-deductible.

<u>New Chance for PPP Monies</u>

Did you miss out on your prior opportunities to receive tax-free PPP cash? Many did miss out. Why? One reason: the word "loan." Who wants a loan? No one. Well, almost no one.

But who wants a tax-free cash gift? If you do, read on for the details. But first, you should know that the big picture works like this:

1. You obtain your tax-free PPP monies from a lender (it's called a "loan," but watch that word disappear as you read on).
2. You spend all the PPP money on yourself if you are self-employed or operate as a partnership; on payroll (including pay to you, if that applies); and on other covered expenses such as rent, interest, utilities, operations, property damage, suppliers, and worker protection.
3. You apply for loan forgiveness and achieve 100 percent loan forgiveness, which is easy when you spend 60 percent or more of the money on payroll (and yourself if you are self-employed or a partner in a partnership).
4. You deduct the expenses that you paid with the PPP loan monies that were forgiven.

New Money on the Table

The new COVID-19 stimulus act sets aside $35 billion for first-time PPP applicants, with $15 billion of that made in loans for first-time applicants with 10 or fewer employees or made in amounts less than $250,000 to businesses in low-income areas.

New Deadline

The new deadline of March 31, 2021, replaces the expired deadline of August 8, 2020. The monies available in this new round of PPP funding are on a first-come, first-served basis. Don't procrastinate. Get your application for your first-time PPP monies in now.

New Stimulus Law Grants Eight Tax Breaks for Individual Filers

As you have likely read, Congress recently passed a massive new stimulus bill that was enacted into law on December 27, 2020. Most of the public's attention has been focused on the bill's authorization of additional stimulus checks, new PPP loans, and other aid targeted to struggling businesses. But Form 1040 American taxpayers who are not in business are struggling as well. The stimulus bill contains a hodgepodge of eight new or extended tax breaks intended to help Form 1040 filers.

None of these tax breaks are earthshaking by themselves, but together they add up to a nice tax present for COVID-19-weary Americans.

Here are the eight new tax breaks that can help you:

1. Deduct cash contributions to charity if you don't itemize.
2. Deduct up to 100 percent of your adjusted gross income (AGI) as a charitable deduction.
3. Lengthen to one year the time you have to repay your 2020 employee Social Security taxes if your employer deferred them.
4. Deduct medical expenses in 2021 using the now-extended 7.5 percent of AGI floor for these deductions.
5. Carry over unused flexible savings account (FSA) funds to next year.
6. Use your 2019 income to qualify for the earned income tax credit and/or the child tax credit if you're a lower-income taxpayer.
7. Deduct out-of-pocket expenses for personal protective equipment (PPE) if you are a teacher.
8. Take advantage of the lifetime learning credit in 2021 if you are a higher-income taxpayer.

Proof for the Home-Office Deduction

Question. If you have an office outside your personal home—say, downtown—can you have a tax-deductible office inside your home for the same trade or business?

Answer. Yes.

Q. Who says that?

A. The IRS.

Q. Show me where they say that!

In IRS Publication 587, the IRS says this:

Your home office will qualify as your principal place of business if you meet the following requirements:

1. *You use it exclusively and regularly for administrative or management activities of your trade or business.*
2. *You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.*

The quote above mirrors the law and the legislative history. Note the following points:

- The administrative office is a "principal" office.
- You must use this office *exclusively* for business.
- You must use this office *regularly* for business.
- You must do your administrative work in your home office.
- You must not do your administrative work in the office outside the home.

Here is a second important quote from IRS Publication 587:

You can have more than one business location, including your home, for a single trade or business.

The IRS makes this rule very clear and straightforward: you may have more than one office for your business, including an office in your home.

The office in the home deduction has always been a favorite audit target as most taxpayer do not meet the basic qualifications. The 2017 Tax Act removed the deduction from Federal returns for employees (*eliminating the category of unreimbursed employee business expenses*). However, that deduction is still available for CA returns (*as well as for a number of other states*). Self-employed taxpayers (*filing a Schedule C*) are still eligible for claiming the deduction. Shareholders of corporations are deemed employees so they cannot claim a home office deduction on Schedule A.

An important point – *take pictures of your home office now and keep them in a safe place.* The reason is that it may be a couple of years before the IRS gets around to looking at your return, and then asking you for evidence of the home office. If you have moved out of that home by the time of the audit, or converted the office back to its former use, it will be too late to get a picture.

Be sure the home office looks like a home office. If you convert a bedroom, try *not* to have it still look like a bedroom. I converted one of our bedrooms to my home office. Anyone who has seen it would immediately conclude it was an office because of 6 printers scattered about the room, 2 computers, bookcases, file cabinets, shelves filled with tax books and other related items, and a large desk with a couple of chairs for clients. Gone is the bed and the frilly pictures. Instead, the wall coverings are my U.S. Treasury license, the City of Burbank license, Oxy diploma and some IRS memorabilia from my past employment with that agency.

Trying to deduct a portion of a room (*like a corner of a large master bedroom)* is very difficult as it is impossible (generally) to pinpoint where the personal space ends and the office begins. Further, the bedroom is a mixed-use space violating the rule that it must be used exclusively for business. Going to a retailer and buying 6' tall dividers to make a "cage" around the business area *may* work. *But who wants dividers in their bedroom?* The point is that the IRS must be able to clearly identify the business use space.

Bottom line – the first impression is a lasting one, so if you have converted a bedroom or another space, my advice – *go all the way with the conversion so an IRS Agent would have no reservations about deeming it indeed an office in the home*.

Child and Dependent Care Credit and the America Rescue Plan Act

There were some improvements made by the 2020 American Rescue Plan Act (ARPA) to the child and dependent care tax credit for the 2021 tax year (*next year's return!),* i.e., the credit available for expenses a taxpayer pays for the care of qualifying individual(s) under the age of 13 so that the taxpayer can be gainfully employed.

For a care expense to qualify for the credit, the expense must be "employment-related," i.e., it must enable you and your spouse to work, and it must be for the care of your child, stepchild, or foster child, or your brother or sister or step-sibling (*or a descendant of any of these*), who is under 13, lives in your home for over half the year, and does not provide over half of his or her own support for the year. The expense can also be for the care of your spouse or dependent who is handicapped and lives with you for over half the year.

The cost of household services, e.g., domestic help, can also qualify as long *as the cost at least in part goes towards the care of the individual*. I can see this being an issue for the IRS unless the caregiver itemizes his or her invoice to separate out the cost for cleaning, etc and the cost for actual care of the dependent.

The typical expenses that qualify for the credit are payments to a day-care center, nanny, or nursery school. Sleep-away camp ***does not qualify***. The cost of kindergarten or above does not qualify because it is primarily an education expense. However, the cost of before and after school programs *may* qualify as care expenses.

To claim the credit, *married couples must file a joint return*. For purposes of this rule, a valid same-sex marriage that is authorized under state or foreign law is recognized, but a registered domestic partnership (*such as is available in CA*) or a civil union does ***not*** qualify.

The 2021 credit is refundable as long as either you or your spouse has a principal place of abode in the U.S. for more than one-half of the tax year.

Further, you must provide the care-giver's name, address, and social security number (*or tax ID number if it is a day-care center or nursery school).* A day-care center must be in compliance with state and local regulations.

You also must include on the return the social security number of the children who receive the care. There is no credit without it. Omission of the social security numbers while still claiming the credit will result in a summary assessment of tax liability against you.

When calculating the credit, several limits apply:

First, qualifying expenses are limited to the income you or your spouse earns from work, self-employment, or certain disability and retirement benefits—using the figure for whichever of you earns less. Under this limitation, if one of you has no earned income, you will not be entitled to any credit. However, under certain conditions, when one spouse has no actual earned income and that spouse is a full-time student or disabled, the spouse is considered to have monthly income of $250 *(if the couple has one qualifying individual*) or $500 (*two or more qualifying individuals*).

For 2021, the first $8,000 (*increased from $3000*) if you have one qualifying individual, or $16,000 (*up from $6000)* if you have two or more qualifying individuals, of care expenses generally qualifies for the credit. However, if your employer has a dependent care assistance program under which you receive benefits excluded from gross income, the qualifying expense limits *($8,000 or $16,000*) are reduced by the excludable amounts you receive.

Example 1: George pays $8,400 in qualified employment-related expenses in 2021 to care for his two children while he is working. The children are both qualifying individuals. George can take the entire $8,400 into account in calculating the child and dependent care credit. For tax years other than 2021, the maximum amount of qualified employment-related expenses that George could take into account for purposes of determining the credit would be $6,000.

The credit will be computed as a percentage of your qualifying expenses depending on your AGI. The applicable percentage of qualifying expenses has been increased to 50% (*from 35%) but* is reduced by 1% for each $2,000 (*or fraction thereof*) by which your AGI for 2021 exceeds $125,000 (*up from $15,000*). If your AGI is $125,000 or less, the maximum amount of the credit is $4,000 *($8,000 x 50%)* for taxpayers with one qualifying individual and $8,000 *($16,000 x 50%)* for taxpayers with two or more qualifying individuals.

Example 2. Assume the same facts as in Example 1. George has an AGI of $122,000. His applicable percentage is 50%, and his credit amount is $4,200 ($8,400 x 50%). Had George's AGI been $132,000, his applicable percentage would be 46%, and the credit amount would be $3,864 ($8,400 x 46%).

New for the 2021 tax year is a further phaseout of the credit for high income individuals. The phaseout percentage is 20% (*instead of 50%)* reduced (*but not below zero*) by 1 % for each $2,000 (*or fraction thereof*) by which AGI for 2021 exceeds $400,000.

In sum, the applicable percentage is 50% for taxpayers with AGI of $125,000 or below. The applicable percentage decreases one percent for every $2,000 (*or fraction thereof*) by which the taxpayer's AGI exceeds $125,000 until AGI reaches $185,000. The applicable percentage is 20% for taxpayers with AGI greater than $185,000 but not greater than $400,000. For taxpayers with AGI above $400,000, the applicable percentage again decreases one percent for every $2,000 (*or fraction thereof*). Thus, for taxpayers with AGI greater than $440,000, the credit is phased out completely.

Example 3. Assume the same facts as in Example 1. George's AGI is $420,000. His applicable percentage is 10% (20% -($20,000/$2,000 x 1%)), and his allowable credit is $840 ($8,400 x 10%).

Note that a credit reduces your tax bill dollar for dollar. Thus, in Example 2 above, George pays $4,200 (or $3,864 with AGI of $132,000) less in taxes by virtue of the credit.

I hope the above clarifies the essential elements of the enhanced child and dependent care credit for you in 2021 as a result of ARPA.

I know this was a long newsletter, but I had a lot to cover. I hope that you find the information in this newsletter of value to you. Above all else, please get your shots (*or shot*) as soon as possible and stay safe.

Very truly yours,

Dick Norton

> ***This newsletter is not intended or written by me to constitute written advice that you may rely upon to avoid penalties that may be imposed by any taxing authority. Selection of a tax entity may have considerations beyond simply its tax treatment. Therefore, I advise clients to always first consult with an attorney who is intimately familiar with business forms and their relevance to potential future tax and financial issues.***