Tax Roundtable July 20, 2017 - QUESTIONS

**Leroy asks:**

My question is about a new client (Husband) that's reaching out for help. His scenario is this:

They are a middle aged married couple of 11 yrs, they have a 20 yr old step son (the wife’s son)  that works  part-time, and he's not in school. They all live in the same household. The wife has filed  (HOH) since 2008, and the husband has filed (MFS) for the same amount of time due to financial disagreements over a period of time.

Their gross income is 106,000. The wife (49,000) & the husband (57,000). The wife has a tax preparer, they split the mortgage in half, bank loan payments in half,  give to their church, go half on groceries, and the husband pays all of the utility bills, line of credit payments, and he also turned a spare vacant bedroom into a home office for his consulting business for the past year.

But, when tax time comes, the wife claims all the mortgage interest, bank interest, church contributions, and whatever else she can claim and doesn’t want the husband to claim anything that he's paid for over the course of the year. How should I approach this situation so that it keeps the husband in compliance with (IRC)? The wife is fixed on continuing to file (HOH) no matter what. Thanks in advance for your insight and advice.

**ANSWER**: There is no good solution to this. The wife’s preparer is preparing fraudulent tax returns.   
(ARE they really married?) If they really are married, there is absolutely NO way she can legally be filing as HOH.

There is very little you can do for this man with the deductions SHE insists on claiming.   
You keep filing him as MFS, showing his wife’s SSN. (If the IRS hasn’t audited yet, that’s a surprise.)  
You cannot have him deduct the mortgage interest that she is claiming. Not even on the Office in Home – just other costs, like insurance and utilities.

Note: You can put this in writing, with the citations that specify that she may not file as HOH as long as she is married and living under the same roof – and give a copy of the general laws (not specific to her) to her tax pro. She will be furious. You will cause marital problems. And you will lose the client, anyway.

**Cherie has two questions:**

I need to clarify some S-Corp questions.  I am trying to determine shareholder basis for the personal return & encountered issues/questions when reviewing their S-Corp return that had been prepared elsewhere.  If this discussion does not fit with tomorrow's roundtable agenda, I understand & will post elsewhere.

**Question I.**  Married couple are only shareholders in an S-Corp (HHS).  They took money (~30K) from a home equity line (primary residence is collateral) to "invest" in the S-Corp they started.

Q1: **the money is considered capital contributed to the S-Corp and is their initial basis, correct?**

Q2: **they are allowed to deduct the home equity interest on their personal retur**n (Sch A) provided the mortgage amounts do not exceed home equity limits, correct?  *(they are far below home acquisition debt and home equity debt limits)*.

Q3: **alternatively, they may deduct the home equity interest as a business expense** on the S-Corp return if they can show that the equity funds were only used for the business, thus all of the interest is for business expenses.  Correct?

**Answers:**

**Answer Q1** – I don’t know. How did they treat it in the S corp?  
Did they buy stock in the S corp?   
Did they lend the money to the S corp?  
Did they simply make this a capital contribution without buying stock?  
  
a) You need to ask them what they believe they did.

b) You need to see their corporate kit to see if any stock was issued.

c) If this took place in 2016, and nothing has been filed yet, YOU can help them decide how to treat this.

**Answer Q2**. Yes, they may treat this a personal mortgage deduction.  
Remember to pick up the interest on Form 6251. This interest is subject to AMT.

**Answer Q3**. That depends.   
  
a) If they want to treat this as an INVESTMENT into the business, this would be investment interest, reported on Form 4952. Then the interest is limited to investment income. AND it converts capital gains income to ordinary income, up to the amount of the deduction.  
b) If this is meant to be LOAN taken out by the corporation, you will have to make an election on the personal tax return to treat this as a business loan. Then, this is not a stock purchase, it’s a loan and the corporation pays this directly to the lender.

**Question II**.  The purpose of the S-Corp is to "flip houses".  The S-Corp purchased 2 houses in 2016, but did not sell either of them or generate any other income for the S-Corp.

Q1:  My understanding is that up to $5000 of startup costs may be deducted in the year in which the "active conduct of the business begins". Usually auditors (and other IRS personnel) translate "active conduct" as the year in which the business begins to generate income -- i.e., expenses with $0 income is a major "red flag".  **In this scenario (houses bought as inventory, but no sales yet), is the S-Corp eligible to deduct startup costs in 2016**?

Q2:  A signification portion of the startup costs was training on "flipping houses", real estate, etc.  **Is such training included as "startup costs"?**

**Answers:**

**Answer Q1:** Good question. Their business is to buy and sell houses.   
They have no income, so taking deductions would instantly red-flag the return.   
But, it’s not a Schedule C…so it’s less likely to be audited.  
The question really is – DO THEY HAVE START-UP costs – or are their costs meant to be capitalized as part of the houses?

**Answer Q2:** Training on flipping houses – education to learn a new profession? Generally, that’s not even a deductible cost in the first place. I wouldn’t deduct it. Capitalize it all as part of the cost of the houses – split the cost between the two houses.

This is my opinion…you need to decide what to do.

But, if they are serious about this flipping thing, they will fix up and sell the houses this year. And these costs will reduce their short-term sale profits.

**Question** **III.**  The couple also started another S-Corp (HAM) in 2016 (same shareholder terms) -- purpose is to hold houses they plan to rent.  The downpayment for the 2 houses purchased as "inventory" for the HHS S-Corp was paid directly from the HAM checking account.

Q1:  **How would this transaction (money paid by another S-Corp) be classified in terms of their individual shareholder basis/capital contribution to the HHS S-Corp that owns the houses?**

I was not consulted about any of the S-Corp activity before they came in for their 2016 personal returns. I appreciate your assistance.

**Answers:**

Oh swear!! Who is selling them all these entities?  
  
This should have been the first question you asked – since this changes the whole picture.  
The first S corp you asked about doesn’t own the properties. You didn’t tell me that.

So the first S corp gets NO deductions at all. Period.  
They are in the business of remodeling and effecting the sale of the property.  
They are meant to get income when they properties are sold.  
So no, they have not started business yet.   
  
AND there needs to be a contract between HAM and HHS defining the role of HHS and how they are to be compensated.   
  
And in this case, I don’t even see how HHS can deduct the training, since they can’t capitalize it in the houses, because HHS doesn’t own the houses. HHS is basically a repair business.

BE CAREFUL ABOUT THE NAICS CODES YOU SELECT TO DEFINE THESE BUSINESSES!

Now, to answer your question – read all their articles of incorporation and how everything is defined.  
Did each shareholder invest (or lend) money in (or to) either of the corporations?  
  
What percentage does each shareholder own?  
Did they actually put money into HHS at all?   
Since HAN owns the properties, that’s where the money went. So what funds went into HHS?  
Where are they getting the money to fix up the houses?

You have some questions to ask them.   
Think it through clearly, step-by-step on how each entity works.

Bernice asks  
  
Question:  
Don't really get how to start a 1041 from the beginning. I've done a couple of returns that have K-1's that come from trust accounts that were set up before with 1041 taking a % or half of income from various sources and splitting these amounts between the 1041 and the 1040 but I really don't know how to start one.. ie, my husbands  and another mother of a friend that died at the end of 2015! but had various things to dispose of by her son (adm) at the end of 2016.  I rec. her info with his "16 tax return papers a few months ago so this should have been done then at least!.

Clearly, I need a road map -- outline of order of duties to finish and START the 1041 and so far haven't figured it out.  Told it's simple, but I'm making things too complicated, as usual, and never a good idea.

Another lady friend has one needing to be done - she a beneficiary that had to send on about $200K of a $550k inheritance - all cash amounts from various people thru the deceased - but not stock ro Irs def. income so it should be tax free, right?  I need to get the 706 in there (?) to make that happen, right?

**Answers:**

**Answer Q1 -**

Here are some resources

A very specific organizer for Form 706 information – from the AICPA <file:///C:/Users/taxmama/Downloads/Estate%20Tax%20Organizer%20706.pdf>

Step-by-step instructions to Form 1041 – from the AICPA <http://www.aicpa.org/membership/downloadabledocuments/sample_files_/taxsection/sample-2014-form-1041-estate-and-trust-tax-return-checklist-long.pdf>

And some extra stuff…

Introduction to Estate & Gift Taxation Class

<https://www.youtube.com/watch?v=3FaaWYtkhvg> (about an hour)

A nice, short outline of what goes into the Form 706  
<http://miorinilaw.com/global_pictures/preparing_a_federal_estate_tax_return.pdf>

A checklist of documents needed  
<http://www.petersonjakecpa.com/documents/1041_checklist.pdf>

A nice, simple resource - <http://www.dummies.com/personal-finance/estate-planning/how-to-compile-supplemental-documents-for-estate-form-706/>   
<http://www.dummies.com/store/product/Estate-and-Trust-Administration-For-Dummies-2nd-Edition.productCd-1118412257,navId-322443,descCd-tableOfContents.html>

**Answer Q2 -**

I don’t really understand this question. Especially, what is “but not stock ro Irs def”? With an estate this small, that’s only composed of cash, there may not need to be an estate (Form 706) at all. I would just prepare a Form 1041 and show the distributions on the K-1. If the accounts were in banks, there might be some interest income to split up among the other beneficiaries.