Learning Objectives

- Apply tax rules for rental and vacation properties
- Explain treatment of passive income/losses
- Identify tax treatment of various deductions for AGI
- Understand treatment of Individual Retirement Accounts (IRAs)
- Explain contribution and distribution rules for other retirement plans
- Explain pension plan rollover rules
Rental Income/Expenses

- **Net Rental Income/Loss is part of taxpayer’s gross income**
  - Report on Schedule E - Part I

- **Vacation Homes**
  - If both personal and rental use of residence, must allocate expenses
  - Deductions limited based on period of time residence used for personal vs. rental
Homes With Dual Use – Rental and Personal

Three Categories – different tax treatment for each

- **Category I**: Primarily personal use
  - Rented for less than 15 days

- **Category II**: Primarily rental use
  - Rented more than or equal to 15 days
    and
    Personal use **does not** exceed greater of 14 days or 10% of rental days

- **Category III**: Rental/personal (dual use) of property
  - Rented more than or equal to 15 days
    and
    Personal use exceeds greater of 14 days or 10% of rental days

See following screens for tax treatment for each scenario
Primarily Personal Use

- Treated as a personal residence
- Rental period is disregarded
  - Rental income is not taxable
  - Mortgage interest and real estate taxes reported on Schedule A (itemized deductions)
  - Other expenses are personal and nondeductible
Primarily Rental Use

- Must allocate expenses between rental and personal use – calculated as follows:
  - Rental days / Total days used = Rental %
  - Expenses x Rental % = Rental deductions
  - Personal days / Total days used = Personal %

- If rental deductions exceed rental income, can deduct against other income, subject to passive loss rules

- Personal % of mortgage interest and real estate taxes reported on Schedule A
Rental/Personal (Dual) Use

- Allocate expenses between rental and personal based on same allocation formulas as prior screen.

- Rental deductions can be taken up to amount of rental income only, in order, as follows:
  - Taxes and interest (can take into loss situation)
  - Utilities/maintenance (only up to remaining rental income)
  - Depreciation (only up to remaining rental income)

- Personal % of mortgage interest & real estate taxes reported on Schedule A.
Example of Dual Use Rental Property

Example
The Prebena family owns a ski condo in Alta, UT; in the current year personal use = 25 days and rental use = 50 days. Data pertaining to the rental follows - what amounts will be reported on Schedules E and A for the current year?

- Rental income $10,000
- Taxes $1,500
- Interest $3,000
- Utilities $2,000
- Insurance $1,500
- Snow removal $2,500
- Depreciation $12,000
Example
The Prebena family owns a ski condo in Alta, UT; in the current year personal use = 25 days and rental use = 50 days. Data pertaining to the rental follows; what amounts will be reported on Schedules E and A for the current year?

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td>$10,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>$1,500</td>
</tr>
<tr>
<td>Interest</td>
<td>$3,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>$2,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>$1,500</td>
</tr>
<tr>
<td>Snow removal</td>
<td>$2,500</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

Solution

Step 1: Personal use is > 14 days or 10% of rental (5 days); therefore, does exceed the greater number and this is dual use property

Step 2: Taxes/interest = $4,500 x 50/75 = $3,000 deduction on E

Step 3: Other expenses = $6,000 x 50/75 = $4,000 deduction on E

Step 4: Depreciation = $12,000 x 50/75 = $8,000 but limited to $3,000 (remaining income) because dual use property can’t create a loss

Step 5: What amount goes to Schedule A? ($4,500 taxes/interest – $3,000 rental = $1,500)

Step 6: What is the loss carry forward? $8,000 – 3,000 = $5,000
Alternative Allocation Method

- IRS requires that dual use of rental property allocation is based on total days of use.
- U.S. Tax Court has allowed allocation of interest and taxes using 365 as denominator.
  - This allows more interest/taxes to be deducted on Schedule A, creating greater potential to take other expenses on the Schedule E.
- This controversy between IRS and Tax Court is still not resolved.
Categories of Income

Three types of income

- Active – This is from wages, salaries and self-employment income
- Portfolio – This is generated from dividend and interest income
- Passive – This is from items such as limited partnerships and rental real estate
Passive Loss Limitations

- **Passive loss rule** - When taxpayer has minimal or no involvement in an activity, generated losses are considered “passive” and may not be deducted in excess of passive gains. However -
  - Losses can be carried forward and deducted in future years
  - They can be deducted when investment is sold

- Passive losses cannot generally be used to offset active or portfolio income
Passive Loss Limitations - Exception

- Rental property is specifically designated as passive, even if taxpayer actively manages.

- However, individual taxpayers
  - May take up to $25,000 of rental loss (even though considered passive) against ordinary income
  - The $25,000 loss capability is reduced by 50¢ for each $1 Modified AGI (MAGI) > $100,000*

- Different rules apply if married filing separately

*Therefore, no deduction for rental losses exists when MAGI reaches $150,000
Passive Loss Limitations

- If taxpayer is heavily involved in real estate rental activities, may be considered to have an active business.

  - Requirements for this are:
    - 50% or more of individual’s personal service during year is performed in real property trade and
    - More than 750 hours of service performed

- The taxpayer may then be able to deduct entire loss on real estate business.
Rental Real Estate Loss Example

Example
Bobbi Jo is single and owns one rental duplex that showed a loss of $20,000. Her modified AGI before the loss is $118,000. What amount of the rental loss can be claimed?
Example
Bobbi Jo is single and owns one rental duplex that showed a loss of $20,000. Her modified AGI before the loss is $118,000. What amount of the rental loss can be claimed?

Solution
Step 1  Modified AGI exceeds $100,000 (therefore, $25,000 allowable loss may be reduced)

Step 2  $118,000 - $100,000 = $18,000 excess,
        $25,000 - ($18,000 x 50%) = $16,000

Only $16,000 of the rental loss can be deducted
Bad Debts

- Bad debts arise when taxpayer sells goods/services on credit and accounts receivable later becomes uncollectible
  - Deduction for bad debts allowed up to amount previously included in income - *cash basis taxpayers cannot take bad debts expense* as they never reported original income

- Must use specific charge-off method
  - IRS requires proof of worthlessness
Bad Debts

Two categories of bad debts

- Business bad debts are ordinary deductions
  - Those that arise from trade/business
  - These are deductible

- Non-business bad debts are short-term capital losses, which are netted against other capital gains and losses
  - Report on Schedule D
  - Subject to $3,000/year loss limitation (discussed in Chapter 8 in more detail)
Example

Keiko (a dentist) loans her friend, Lars, $20,000 to start an upholstery business. Subsequently, Lars cannot repay Keiko. Is this a business or a non-business bad debt and how much may Keiko deduct in the current year?
Example
Keiko (a dentist) loans her friend, Lars, $20,000 to start an upholstery business. Subsequently, Lars cannot repay Keiko. Is this a business or a non-business bad debt and how much may Keiko deduct in the current year?

Solution
This is a non-business bad debt as Keiko is not in the business of loaning money. It is a short-term capital loss (limited to $3,000 of deduction against ordinary income in any one year). She may carry forward the balance of the capital loss to future years.
Inventories

- Cost of Goods Sold (COGS) is a significant deduction for many retail businesses
  - Cost of beginning/ending inventory crucial to calculation of deduction
  - LIFO and FIFO most commonly used methods of costing inventory

- If LIFO is used for tax, it must also be used for financial statement purposes
  - Form 970 used to elect LIFO
Net Operating Losses (NOL)

- NOLs are losses resulting from business and casualty items only
- First, carry it back two years and then forward twenty
  - File amendments for prior years on Form 1040X or Form 1045 (for quick claim for refund)
  - or
- May make an irrevocable election to forego carry back, then carry forward
  - But must elect this in year of loss

Businesses that incurred an NOL in 2008-2009 are allowed to elect to carry back the NOL to the most beneficial year (3, 4, or 5 years at the election of the taxpayer). This provision may be extended to 2010. The taxpayer may elect to forego the carry back, and then carry forward.
Types of Individual Retirement Accounts (IRAs)

- **Traditional IRA**
  - Deduction *for AGI* if certain conditions met
  - Distributions in retirement are taxable

- **Roth IRA**
  - No current deduction
  - Distributions in retirement are nontaxable
Contributing/Deducting - IRA

- Roth or traditional IRA contribution limited to lesser of:
  - 100% of earned income
  - $5,000

  Spouse with no earned income will be able to contribute up to $5,000
  For 2010, taxpayers and spouses age 50 and over can contribute an additional $1,000/year (called “catch-up provision”)

Can make contributions up through April 15, 2011 for 2010
Contributing and Deducting to a Roth IRA

- Roth IRA contribution maximum is reduced for all taxpayers over certain income levels
  - Phase-out for contribution is reflected in table on page 3-17
  - Does not matter whether one spouse is an active plan participant or not

- If taxpayer contributes to both a traditional and Roth IRA, combined amount cannot exceed $5,000 ($6,000 if 50 or over)
Contributing/Deducting Traditional IRA

- Traditional IRA deduction is dependent on AGI and active participation in another qualified retirement plan
  - Single taxpayers – see table on top of page 3-18
  - MFJ taxpayers – see table, phase-outs based on if one, both or neither spouse is an active participant

Note: if only one spouse is in a qualified plan, Phase-out for the non-active participant spouse begins when married filing joint couple’s AGI > $167,000
IRA Contribution Example #1

Example
Owen is 42, single, and wants to contribute the maximum to his Roth IRA. His AGI = $105,000, so his contribution will be limited. Please calculate how much of an IRA contribution is allowed. How would that change if Owen were 62?
Example
Owen is 42, single, and wants to contribute the maximum to his Roth IRA. His AGI = $110,000, so his contribution will be limited. How much of an IRA contribution is allowed? How would that change if Owen were 62?

Solution
Look at the phase-out chart on p. 3-17. The denominator to the calculation is the range of the phase-out amounts*

\[
\frac{($120,000 - $110,000)/$15,000}{\text{x $5,000}} = $3,333 \text{ Roth IRA contribution}
\]

If he were 62:
\[
\frac{($120,000 - $110,000)/$15,000}{\text{x $6,000}} = $4,000 \text{ Roth IRA contribution}
\]

* $120,000 - $105,000
IRA Contribution Example #2

Example

Liza and Mikal (both 41) filed married filing jointly. Liza is covered by a 401(k) plan at work and earns $96,000. Mikal is not covered by a plan at work and earns $30,000. How much can each of them contribute to a traditional IRA?
Example
Liza and Mikal (both 41) are MFJ; Liza is covered by a 401(k) plan at work and earns $96,000. Mikal is not covered by a plan at work and earns $30,000. How much can each of them contribute to a traditional IRA?

Solution
Their combined AGI = $126,000. Their AGI exceeds the top end of the phase-out range for MFJ for ‘active participant spouse’, per Note 1 in the table on page 3-18.

Since Liza is the active plan participant and their joint income exceeds the upper phase-out limit, she may not make a deductible contribution to a traditional IRA. She could, however, make a $5,000 contribution to a Roth IRA, since their AGI is not in the Roth phase-out range (see table page 3-17).

Mikal can make the full $5,000 traditional IRA contribution since the AGI phase-out for the spouse that is not in an active plan does not kick in until $167,000.
Traditional IRA Distribution

- Distribution taxed as ordinary income
  - Must begin taking distributions by age 70.5
  - There’s a 10% penalty if you take distribution before age 59.5
  - Penalty-free withdrawals from IRAs may be made by taxpayers who are:
    - Disabled
    - Using special level payment option
    - Purchasing a home for the first time (up to $10,000)
    - Paying higher education expenses
    - Paying medical expenses > 7.5% of AGI or medical insurance premiums for dependents and on unemployment at least 12 weeks
Roth IRA Distribution

- Qualified distributions are tax free as long as Roth IRA was open for five years
  - and
    - Distribution is made on/after age 59.5
    - Distribution is made due to a disability
    - Distribution is made on/after participant’s death
    - Distribution is used for first time homebuyer’s expenses

- If don’t meet above, part of distribution may be taxable. Return of capital is tax-free and earnings are taxed.
Keogh Plan

- Participants must meet minimum age and years of service requirements
- Retirement plan geared towards self-employed individuals
- Tax free contributions are limited to lesser of 20% of net earned income (before Keogh deduction) or $49,000
  - Net earned income includes business profits, if significantly generated from taxpayer’s personal services
  - Must reduce net earned income by \( \frac{1}{2} \) self-employment tax for pension contribution calculation
Simplified Employee Pension (SEP)

- Same dollar limits as Keogh plans, but contributions made to SEP-IRA
  - IRA account with higher funding limits
- Participants must meet minimum age and years of service requirements
- Pay early withdrawal penalty if receive distributions prior to age 59.5
- Must start drawing by age 70.5
Qualified Retirement Plan

- Contributions by an employer to qualified retirement plans are tax deductible
  - Employee contributions are pre-tax
  - Tax on earnings is deferred

- To achieve qualified plan status, an employer-sponsored retirement plan must
  - Be for exclusive benefit of employees
  - Be nondiscriminatory
  - Have certain participation and coverage requirements
  - Comply with minimum vesting requirements
  - Meet uniform distribution rules

- Limitations on contributions to/benefits from qualified plans
  - Defined contribution – annual addition to employee’s account can’t exceed lesser of 25% of compensation or $49,000
  - Defined benefit – annual benefit can’t exceed lesser of $195,000 or average compensation for the highest three consecutive years
Limitations on Certain Qualified Plans

§401(k)

- Employee chooses to defer some compensation into plan
  - Defer means to forego current compensation - the reduction goes into a qualified retirement plan
  - Each employee chooses % of wages to contribute to plan
  - Can’t exceed $16,500/year for all salary reduction plans
    - $22,000/year if 50 or older
- An employer may match to encourage participation, this is excludable from income
- When distributions occur, contributions and earnings taxable
Roth §401(k)

- Beginning in 2006, employers allowed to set up Roth §401(k) plan
  - Employees may defer same annual amount as traditional §401(k), but with no reduction in current taxable income
  - Withdrawals/earnings generally tax free upon distribution

- Expected to be popular with high income taxpayers because no AGI phase-out and much higher annual contribution than a Roth IRA
Low Income Retirement Plan Contribution Credit

- Credit to encourage low-income taxpayer participation in retirement savings
- Tax credit for percentage of retirement plan contribution based upon AGI
  - Credit equal to 50%, 20% or 10% of contribution
  - See chart on page 3-25
  - Credit is direct deduction from income taxes payable
Direct Transfer of Retirement Plan Funds

- Taxpayer instructs trustee of plan to directly transfer assets to trustee of another plan
- No backup tax withholding necessary because $ goes right from one plan to another
- Unlimited number of direct transfers per year
Plan 1 Taxpayer Plan 2

Distribution Rollover of Retirement Plan Funds

- Taxpayer receives assets from fund, and then has 60 days to get 100% of the $ from one plan to another to avoid penalties
  - Or 120 days if first-time homebuyer, waived in certain situations
- 20% federal backup tax withholding is mandatory
  - So taxpayer must make up the 20% withholding and then wait until year-end to get refund!! Also, if under 59.5 years old, portion of plan distribution not transferred subject to 10% penalty!
  - IRA distributions not subject to mandatory withholding
Example
Theo is 54 and instructs her employer, Ecotrek LLP, to distribute $250,000 of her non-IRA retirement account to her. How much must the trustee of the fund withhold and what must Theo do to avoid taxes and penalties on the distribution in the current year?
Example
Theo is 54 and instructs her employer, Ecotrek LLP, to distribute $250,000 of her non IRA retirement account to her. How much must the trustee of the fund withhold and what must Theo do to avoid taxes and penalties on the distribution in the current year?

Solution
The trustee must withhold 20%; therefore, Theo will receive $200,000 ($250,000 less withholding of $50,000). To avoid taxes she must contribute $250,000 to a new fund within 60 days. If Theo does not have the extra $50,000 to contribute, that portion of the distribution will be included in her taxable income and she will be subject to a 10% penalty. If she can contribute the full $250,000; the amount withheld will be accounted for on her annual tax return.
The End