**Chapter Four**

**Business Income and Expenses, Part II**

**Learning Objective 4.1 Rental Income and Expenses**

Net income from rental property is taxable to the taxpayer. Most rental income is reported on a Schedule E, Supplemental Income and Loss. The allowable deductions for rental property include real estate taxes, mortgage interest, insurance, commissions, repairs and depreciation.

Vacation homes, property used by the taxpayer part of the year and rented out for part of the year, have three special tax considerations. The first is a vacation home designated for primarily personal use. These residences are rented out fewer than fifteen days per year. The rental income is not taxable and mortgage interest and real estate taxes are considered itemized deductions for the taxpayer. Other expenses associated with the renting of the property are not deductible. The second type is property for primarily rental use. This type property is rented fifteen or more days and used for personal purposes for **not more** than fourteen days or ten percent of the days rented, whichever is greater. All expenses must be divided between personal and rental. This arrangement also allows for expenses to exceed income and result in a loss that can reduce other income. The third tax treatment is rental/personal use. This type property is rented fifteen or more days and used for personal purposes for **more** than fourteen days or ten percent of the days rented, whichever is greater. Expense must be allocated between personal and rental with this property type. Most allowable expenses can be deducted up to the amount of income the property generates.

**Learning Objective 4.2 Passive Loss Limitations**

Passive losses, from investments such as limited partnership tax shelters, are limited. Passive losses may not be used to reduce active income (wages, salaries, dividends, interest, etc.). Unused passive losses may be carried forward. Under passive loss rules, real estate rental activities are specifically defined as passive. However, individual taxpayers may deduct up to $25,000 of rental property losses against other income if they actively participate in the management of the property (with a phase-out when AGI before passive losses reaches $150,000). Taxpayers who have real estate rental activities as a substantial part of their total income are determined to be in a trade or business. To be considered a trade or business two criteria must be met. The first criterion is that more than 50 percent of the individual’s personal service income is derived from real property trades or businesses. The second criterion is that the individual performs more than 750 hours of service in the real property trade or business in which he or she claims material participation.

**Learning Objective 4.3 Self-Employed Health Insurance Deduction**

Self-employed taxpayers are allowed an above-the-line deduction for health insurance premiums paid for themselves and their families. Deductible insurance includes medical and dental insurance paid to cover the self-employed taxpayer, spouse and dependent children, medical and dental insurance paid for children under the age of 27 who are not dependents and long-term care insurance paid for the taxpayer and the family of the taxpayer. Taxpayers with income reportable on Schedule C are generally considered self-employed. Taxpayers with earnings from certain partnerships, S Corporations, LLC’s and farm businesses may also be considered self-employed and may be allowed the deduction for self-employed health insurance.

**Learning Objective 4.4 Health Savings Accounts**

Health Savings Accounts (HSAs) are used for the purpose of paying unreimbursed medical expenses by taxpayers who carry qualifying high-deductible medical insurance. HSAs have a price-level adjusted annual limitation for deductions for individuals and families. There is an additional “catch-up” contribution allowed for individuals beginning at age 55 and ending at age 65, the age for Medicare eligibility. Distributions from HSAs are free of tax when used to pay for qualified medical expenses. For 2014, distributions which are not used to pay for medical expenses are subject to both income tax and a 20 percent penalty. Once a taxpayer is 65 years old, distributions may be taken for non-medical expenses and will be subject to income tax, but not the 20 percent penalty.

**Learning Objective 4.5 Moving Expense**

Taxpayers are allowed a deduction for moving. The three tests to qualify for the deduction are:

1. The taxpayer must change job sites. Thus, the employee may work for the same company in the same position but must be at a different location.
2. The minimum distance is fifty miles or more than the distance from the former residence to the former job location.
3. The taxpayer must remain at the new job for a certain period of time. Typically, employees must work thirty-nine weeks at the new job location during the twelve months following the move. Self-employed taxpayers must work at least seventy-eight weeks during twenty-four months following the move.

Qualified moving expenses are either moving household goods and personal effects or traveling from the former residence to the new place of residence. No deduction is allowed for meals.

**Learning Objective 4.6 Individual Retirement Accounts**

To encourage individuals to save for retirement, Congress enacted several tax laws. An Individual Retirement Account (IRA) is an account to which individuals contribute funds for their retirement. The IRA contribution is a deduction from gross income and the fund’s earnings (interest and dividends) are tax-deferred. The maximum annual contribution to an IRA is equal to the lesser of either 100 percent of the taxpayer’s compensation or $5,500 ($11,000 if the taxpayer has a spouse who has no earned income). The maximum contribution to either spouse’s IRA may not exceed $5,500. An additional $1,000 contribution is allowed for taxpayers age 50 and over. These deductions are reduced if other types of plans cover the taxpayer. Additionally, adjusted gross income phase-outs are implemented. To avoid a penalty on traditional IRA distributions, generally distributions cannot begin before age 59 ½ and must begin by age 70 ½. A 10 percent penalty is assessed on the distributions and the distributions are included in gross income. Withdrawals may be made without a penalty assessed if one of the following conditions is met:

1. Disabled
2. Special level payment option
3. Medical expenses in excess of 10 percent (7.5 percent if age 65 or older) of the taxpayer’s AGI
4. Medical insurance premiums paid for the dependents of a taxpayer who has received at least twelve weeks of unemployment compensation
5. Higher education costs including tuition, fees, books and room and board for the taxpayer, the spouse, a child or grandchild
6. First-time home buying expenses up to $10,000

While these withdrawals are not penalized, the amounts are still subject to income taxes.

Another type of IRA is a Roth IRA. Contributions to Roth IRAs are nondeductible; however the qualified distributions are tax-free. Tax-free withdrawals from a Roth IRA may be made after a five-year holding period and any of the following conditions are met:

1. The distribution is made on or after the date the participant reaches age 59 ½.
2. The distribution is made to a beneficiary or estate on or after the participant’s death.
3. The participant becomes disabled.
4. The distribution is used to pay for qualified first-time homebuyer’s expenses.

A distribution will be taxable if the distribution does not satisfy the above requirements. Again, the contributions are subject to AGI phase-outs.

**Learning Objective 4.7 Keogh (H.R. 10) Plans and Simplified Employee Pensions (SEPs)**

Self-employed taxpayers and their employees are eligible to be members of a Keogh Retirement Plan or SEPs. Contributions to these plans are limited to the lesser of 20 percent of their net earned income or $52,000. To avoid penalties, distributions must begin at age 70 ½ but not before 59 ½.

**Learning Objective 4.8 Qualified Retirement Plans Including Section 401(k) Plans**

Employers claim deductions for amounts contributed to qualified retirement plans for their employees. In order to be considered a qualified retirement plan, the following general requirements must be met:

1. The plan must be created for the exclusive benefit of employees or their beneficiaries
2. The contributions and benefits must not discriminate in favor of highly compensated employees
3. The plan must meet certain participation and coverage requirements.
4. Minimum vesting requirements must be met for both the employee and employer contributions
5. Uniform minimum distribution rules must be met.

Several types of plans may qualify, including pension plans, profit-sharing plans, stock bonus plans and employee stock ownership plans (ESOP). Pension plans are either defined contribution plans or defined benefit plans. A defined contribution plan uses the employee’s wage base to define the contribution amount. The annual addition to an employee’s account is not allowed to exceed the lesser of $52,000 or 25 percent of the employee’s compensation. A defined benefit plan uses the specific future retirement benefits to determine the contribution amount. Under this plan, the annual benefit payable to an employee upon retirement is limited to the lesser of $210,000 or 100 percent of the employee’s average compensation for the highest three consecutive years of employment.

A Section 401(k) plan allows an employee to make contributions and defer tax on the compensation. The annual maximum ($17,500 or $23,000 if age 50 and over) is reduced dollar for dollar by amounts contributed to other salary reduction plans. Contributions in excess of the maximum are subject to an excise tax. Beginning in 2006, employers were allowed to set up Roth 401(k)’s for their employees.

The Saver’s Credit, or the Low Income Retirement Plan Contribution Credit, can be claimed by certain low-income taxpayers. The credit rate is 50 percent, 20 percent or 10 percent depending on the taxpayer’s filing status and adjusted gross income. Taxpayers receive up to a 50 percent credit for contribution amounts up to $2,000 or a maximum credit of $1,000.

**Learning Objective 4.9 Rollovers**

Taxpayers are allowed to remove funds from one retirement plan to another plan using one of two methods. The first method is the direct transfer. Assets from one plan are transferred to another plan. The second method is the distribution rollover method. In this method, the taxpayer receives a distribution and then transfers all or part of the funds into a new plan. The taxpayer has a maximum of sixty days to transfer the funds to avoid taxes and penalties. The drawback to this method is that 20 percent of the distribution must be withheld for tax payment. Other rules apply and are very complex.