**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 Schedule E, Supplemental Income and Loss.
* Allowable deductions for rental property include real estate taxes, mortgage interest, insurance, commissions, repairs, miscellaneous expenses and depreciation.

*Vacation homes* defined as property used by the taxpayer part of the year and rented out for part of the year - 3 special tax treatments.

* Primarily personal use - rented out fewer than 15 days per year.
  + Rental income is not taxable
  + Mortgage interest and real estate taxes are itemized deductions
  + Other expenses associated with the renting of the property are *not* deductible.
* Primarily used as a rental - rented 15+ days and used for personal purposes for **not more** than 14 days or 10% of the days rented, *whichever is greater*.
  + All expenses must be divided between personal and rental. - *allows for expenses to exceed income and result in a loss that can reduce other income*, subject to passive loss limitations.
* Dual use - rental/personal use - rented 15 or more days and used for personal purposes for **more** than 14 days or te10% of the days rented, whichever is greater.
  + Expenses 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 and losses from rental activities, *are limited*.

* Passive losses may not be used to reduce active income (wages, salaries, dividends, interest, etc.).
* Unused passive losses may be carried forward.
* *Note: Rental real estate is 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*
    - Phases-out when AGI exceeds $100,000
      * $.50 per dollar of MAGI > $100,0000
    - Essentially, ability to deduct rental losses phases out completely when MAGI = $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 if they meet two criteria
  1. If > 50% of individual’s personal service income is derived from real property trades or businesses.
  2. If 750 hours + of service is conducted 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.

* Taxpayers with income reportable on Schedule C are generally considered self-employed (also certain partnerships, S Corporations, LLC’s and farms)
* Deductible insurance includes medical/dental insurance paid to cover taxpayer, spouse and dependent children
* Includes medical/dental insurance paid for children under the age of 27 who are not dependents
  + Must net advance premium credit received under ACA.
* Long-term care insurance paid for the taxpayer and the family of the taxpayer (within limits).

*Note: Health insurance premiums not allowed for any months in which*

*taxpayer can participate in a subsidized health care plan.*

**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*.

* 2016 can contribute $6,750 for a family or $3,350 for self only
  + Additional “catch-up” of $1000 per person for ages 55-65
* Distributions from HSAs are free of tax when used to pay for qualified medical expenses.
  + Distributions which are not used to pay for medical expenses are subject to both income tax and a 20% penalty.
  + At 65 years old, distributions may be taken for non-medical expenses and are subject to income tax, but not the 20% penalty.

There are also three other types of tax-favored medical spending plans

1. Medical Flexible Spending Arrangements (FSAs),
2. Health Reimbursements Arrangements (HRAs) and
3. Medical Savings Accounts (MSAs or Archer MSAs).

**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.
2. The taxpayer must move a minimum distance of 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.

* EEs must work 39 weeks at the new job location during the 12 months following move.
* Self-employed taxpayers must work at least 78 weeks during 24 months following move

Qualified moving expenses are either moving household goods and personal effects or traveling from the former residence to the new place of residence and must be reasonable. No deduction is allowed for meals. *Note: Standard mileage for 2016 = $.19/mile*

**Learning Objective 4.6 Individual Retirement Accounts**

To encourage individuals to save for retirement, Congress enacted several tax laws.

* A traditional Individual Retirement Account (IRA) is an account to which individuals contribute funds for their retirement.
* It is a *deduction from gross income* and the fund’s earnings (interest and dividends) are tax-deferred.
* Max annual contribution to IRA is equal to the lesser of either 100% 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+
  + Phase-outs are imposed and depend upon *whether one, both or neither spouse is an active participant in a retirement plan*.

***See tables on pages 4-20 for phase outs on traditional IRAs***

* Cannot begin distributions before age 59 ½ (or must pay 10% penalty) and must begin by age 70 ½.

Early withdrawals may be made without a penalty assessed if one of the following conditions applies to the taxpayer:

1. Disabled
2. Using a special level payment option
3. Incurred medical expenses in excess of 10 percent (7.5 percent if age 65 or older) of the taxpayer’s AGI
4. Paid medical insurance premiums for the dependent(s) of a taxpayer who has received at least twelve weeks of unemployment compensation
5. Incurred higher education costs including tuition, fees, books and room and board for the taxpayer, the spouse, a child or grandchild
6. Withdrew funds due to an IRS levy
7. First-time home buying expenses up to $10,000
8. He/she is a beneficiary due to the death of the IRA owner
9. A qualified reservist

*Note: 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* but qualified distributions are tax-free.
  + Annual contributions = $5,500 or $6,500 if age 50 or older.
  + Phase-outs apply (see table on page 4-19)
  + Tax-free withdrawals from a Roth IRA may be made after a 5-year holding period and if *any of the following conditions are met:*

1. Distribution is made on or after the date the participant reaches age 59 ½.
2. Distribution is made to beneficiary/estate on or after participant’s death.
3. The participant becomes disabled.
4. 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 Small Business and Self Employed Retirement Plans**

This is a complex area with many tax preparers *turning to pension specialists* for help.

* Self-employed taxpayers and their employees are eligible to be members of a Simplified Employee Pension (SEPs).
  + In 2016 - contributions limited to the lesser of 25% of comp or $53,000.
* Many types of including SEP-IRAs, SIMPLE IRAs or Payroll Deduction IRAs.
* To avoid penalties, distributions must begin at age 70½, but not before 59 ½.

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

ERs claim deductions for amounts contributed to qualified retirement plans for their EEs.

* A qualified retirement plan must meet following:

1. The plan must be created for the exclusive benefit of EEs or their beneficiaries
2. Contributions/benefits can’t discriminate in favor of highly compensated EEs
3. The plan must meet certain participation and coverage requirements.
4. Minimum vesting requirements must be met for both the EE and ER 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.
* *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 $53,000 or 25% of the employee’s compensation.
* *Defined benefit plan* uses the specific future retirement benefits to determine the contribution amount.
  + The annual benefit payable to an employee upon retirement is limited in 2016 to lesser of $210,000 or 100% of the EE’s average compensation for the highest 3 consecutive years of employment.
* A *401(k)* plan allows an EE to make contributions and defer tax on the compensation.
* 2016 annual maximum ($18,000 or $24,000 if age 50 and over) is reduced $ for $ by amounts contributed to other plans.
* Contributions in excess of the maximum are subject to an excise tax.
* Roth 401(k)’s also allowed
* The Saver’s Credit, or the Low Income Retirement Plan Contribution Credit, available to certain low-income taxpayers.
* The credit rate is 50%, 20% or 10% depending on taxpayer’s filing status and AGI
* Taxpayers receive up to a 50% credit for contribution amounts up to $2,000
* Maximum credit of $1,000.

**Learning Objective 4.9 Rollovers**

Taxpayers are allowed to transfer funds from one retirement plan to another plan using one of two methods.

1. *Direct transfer*. Assets from one plan are transferred to another plan.
2. *Distribution rollover method.* Taxpayer receives a distribution and then transfers all or part of the funds into a new plan.
   * Maximum of sixty days to transfer the funds to avoid taxes and penalties.
   * 20% of the distribution must be withheld for tax payment.
   * *Note:* The exception to mandatory withholding is a distribution from an IRS. Other rules apply and are very complex.