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Tax & Business Alert

APRIL 2023

THINKING ABOUT CONVERTING YOUR HOME INTO A RENTAL PROPERTY?

In some cases, homeowners move to new residences, but keep their present homes and rent them out. If you're thinking of doing this, you're probably aware of the financial risks and rewards. However, you also should know that renting out your home carries potential tax benefits and pitfalls.

You're generally treated as a regular real estate landlord once you begin renting your home. That means you must report rental income on your tax return, but you're also entitled to offsetting deductions for the money you spend on utilities, operating expenses, incidental repairs and maintenance (for example, fixing a leak in the roof). Additionally, you can claim depreciation deductions for the home. You may be able to fully offset rental income with otherwise allowable landlord deductions.

PASSIVE ACTIVITY RULES

However, under the passive activity loss (PAL) rules, you may not be able to currently deduct the rent-related deductions that exceed your rental income unless an exception applies. Under the most widely applicable exception, the PAL rules won't affect your converted property for a tax year in which your adjusted gross income doesn't exceed $100,000, you actively participate in running the home-rental business, and your losses from all rental real estate activities in which you actively participate don't exceed $25,000.

You should also be aware that potential tax pitfalls may arise from renting your residence. Unless your rentals are strictly temporary and are made necessary by adverse market conditions, you could forfeit an important tax break for home sellers if you finally sell the home at a profit. In general, you can escape tax on up to $250,000 ($500,000 for married couples filing jointly) of gain on the sale of your principal home. However, this tax-free treatment is conditioned on your having used the residence as your principal residence for at least two of the five years preceding the sale. So, renting your home out for an extended time could jeopardize a big tax break.

What if you don't rent out your home long enough to jeopardize your principal residence exclusion? The tax break you would have gotten on the sale (the $250,000/$500,000 exclusion) won't apply to the extent of any depreciation allowable with respect to the rental or business use of the home for periods after May 6, 1997. It also won't apply to any gain allocable to a period of nonqualified use (any period during which the property isn't used as the principal residence for you, your spouse or former spouse) after December 31, 2008. A maximum tax rate of 25% will apply to this gain (attributable to recapture of depreciation deductions).

SELLING AT A LOSS

Some homeowners who bought at the height of the market may ultimately sell at a loss. In such situations, the loss is available for tax purposes only if the owner can establish that the home was in fact converted permanently into income-producing property. Here, a longer lease period helps an owner. However, if you're in this situation, be aware that you may not wind up with much of a loss for tax purposes. That's because the beginning basis (the cost for tax purposes) when the home is first converted to a rental property is equal to the lesser of actual cost or the property's fair market value when it's converted to rental property. So, if a home was bought for $300,000, converted to a rental when it was worth $250,000, and ultimately sold for $225,000, the loss would be only $25,000. Keep in mind that depreciation deductions while it was a rental property also reduce basis.

This is a complex decision. Contact us for help reviewing your situation. ■

OFFERING SUMMER JOB OPPORTUNITIES? DOUBLE-CHECK CHILD LABOR LAWS

Summertime isn't far off. If you typically hire minors for summer jobs, it's a good idea to brush up on child labor laws before you hire.

In a March 2022 News Release (No. 22-546-DEN), the U.S. Department of Labor's Wage and Hour Division (WHD) announced that the department is stepping up efforts to identify child labor violations in the Salt Lake City area. The news serves as a good reminder to companies nationwide about the many details involved in employing children.

FINER POINTS OF THE FLSA

The Labor Department is the sole federal agency that oversees child labor and child labor laws. The most sweeping federal law that governs the employment and abuse of child workers is the Fair Labor Standards Act (FLSA), enforced by the WHD.

The law restricts the hours that children under age 16 can work and lists hazardous occupations too dangerous for young workers to perform. Examples include the operation of power-driven woodworking machines and jobs that involve exposure to radioactive substances and ionizing radiators.

The FLSA allows 14- and 15-year-old children to work outside of school hours in various manufacturing, non-mining and non-hazardous jobs under certain conditions. Permissible work hours for this age group are:

- Three hours on school days,
- 18 hours in a school week,
- Eight hours on non-school days,
- 40 hours in a non-school week, and
- Between 7 a.m. and 7 p.m. (from June 1 through Labor Day, nighttime work hours are extended to 9 p.m.).

JUST ONE EXAMPLE

The WHD news release reveals the results of three specific investigations. In them, the government found

that employers had allowed minors to operate dangerous machinery and committed other violations.

For example, one restaurant allowed minors to operate or assist in operating a trash compactor and a manual fryer, which are prohibited tasks for 14- and 15-year-old workers. The employer also allowed minors to work:

- More than three hours on a school day,
- More than 18 hours in a school week,
- Past 7 p.m. from Labor Day through May 31,
- Past 9 p.m. from June 1 through Labor Day, and
- More than eight hours on a non-school day.

The WHD assessed the business $17,159 in civil money penalties.

LETTER OF THE LAW

In the news release, WHD Director Kevin Hunt states, "Early employment opportunities are meant to be valuable and safe learning experiences for young people and should never put them at risk of harm. Employers who fail to keep minor-aged workers safe and follow child labor regulations may struggle to find the young people they need to operate their businesses." Employers may also face substantial financial penalties if they fail to follow the letter of the law.

Consult an employment attorney for further details on the FLSA. We can help you measure and manage your hiring and payroll costs, as well as tax responsibilities. ■

BE PREPARED FOR TAXES ON SOCIAL SECURITY BENEFITS

Whether you've filed your 2022 tax return or soon will, one thing you don't want to experience is a surprise. Many older people are caught off guard when they find that their Social Security benefits may be taxable.

How much might you have to pay? That depends on your other income. If you're taxed, between 50% and 85% of your payments will be hit with federal income tax. (There could also be state tax.) This doesn't mean you'll pay 50% to 85% of your benefits back to the government. It means you may have to include 50% to 85% of them in your income subject to regular tax rates.

CALCULATE PROVISIONAL INCOME

To determine how much of your benefits are taxed, you must calculate your "provisional income." Doing so involves adding certain amounts (for example, tax-exempt interest from municipal bonds) to the adjusted gross income on your tax return.

If you file jointly, you'll need to add your spouse's income, and then further add half of the Social Security benefits that you and your spouse received during the year. The result is your joint provisional income.

If you file a joint tax return and your provisional income, plus half your benefits, isn't above $32,000 ($25,000 for single taxpayers), none of your Social Security benefits are taxed. If your provisional income is between $32,001 and $44,000, and you file jointly, you must report up to 50% of your Social Security benefits as income. If your provisional income is more than $44,000, and you file jointly, you need to report up to 85% of your Social Security benefits as income on Form 1040.

For single taxpayers, if your provisional income is between $25,001 and $34,000, you must report up to 50% of your Social Security benefits as income. And if your provisional income is more than $34,000, the general rule is that you need to report up to 85% of your Social Security benefits as income.

SIDESTEP A SURPRISE

If you aren't paying tax on your Social Security benefits now because your income is below the floor, or you're paying tax on only 50% of those benefits, an unplanned increase in your income can have a significant tax cost. In addition to paying tax on the additional income, you may also have to pay tax on (or on more of) your Social Security benefits and you may get pushed into a higher tax bracket.

Contact us for help in accurately calculating your provisional income. We can also assist you with other aspects of tax planning. ■

TAX CALENDAR

April 18

Besides being the last day for individuals to file (or extend) their 2022 personal returns and pay any tax due, first-quarter 2023 estimated tax payments for individuals, trusts, and calendar-year corporations are due today (the states of Maine and Massachusetts have an April 19th federal deadline). Also due are 2022 returns for trusts and calendar-year estates and C corporations, FinCEN Form 114 ("Report of Foreign Bank and Financial Accounts" [but an automatic extension applies to October 16]), plus any final contributions that individuals plan to make to IRAs or education savings accounts for 2022. SEP and profit-sharing plan contributions are also due today if the return is not being extended.

May 1

Employers must file Form 941 for the first quarter (May 10 if all taxes are deposited in full and on time). Also, employers must deposit FUTA taxes owed through March if the liability is more than $500.

May 15

Calendar-year exempt organizations must file (or extend) their 2022 Forms 990, 990-EZ or 990-PF returns.

June 15

Second-quarter 2023 estimated tax payments are due for individuals, calendar-year corporations, estates and trusts.

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IS YOUR WITHHOLDING ADEQUATE?

If you were distressed to find you owed money when you filed your last federal tax return, you might want to change your withholding so that this doesn't happen again. You might even want to adjust your withholding if you got a big refund, because you're essentially giving the government a tax-free loan of your money.

ADJUST IF NECESSARY

Taxpayers should periodically review their tax situations and adjust withholding, if appropriate. The IRS has a withholding calculator to assist you in conducting a paycheck checkup. The calculator reflects tax law changes in areas such as available itemized deductions, the child credit, the dependent credit and the repeal of dependent exemptions. The calculator can be accessed here: https://bit.ly/33iBcZV

LIFE CHANGES

In addition to tax law changes, the IRS recommends that you perform a checkup if you:

- Adjusted your withholding last year, especially in the middle or later part of the year,
- Owed additional tax when you filed your 2022 return,
- Received a refund that was smaller or larger than expected,
- Got married or divorced,
- Had a child or adopted one,
- Purchased a home, or
- Had changes in income.

To modify your withholding at any time during the year, simply submit a new Form W-4 to your employer. Changes typically go into effect several weeks after a new Form W-4 is submitted. (Estimated tax payments can be adjusted each time you make an estimated payment to the IRS.)

PLAN AHEAD

There's still time to remedy any shortfalls to minimize taxes due for 2023, as well as any penalties and interest. Contact us if you have any questions or need assistance. ■