Hons Tax Associates
November 2023 update

Hello all

This November newsletter covers the following:

- Reminders for 2023
- Proposition HH (property tax) defeated
- Rentals (this one subject is longer than usual)

Previous newsletters, including the July one with 2023 new tax provisions, are on Hons-tax.com under "tax posts". Please feel free to call me 303-929-8090 if questions. I am available if financial events or changes for you in 2023 and you need to figure a payment to the IRS to avoid penalties, changes coming up in 2024, and for S Corp owners wanting to adjust their 2023 salary and retirement plans contributions.

IRS closed their e-file doors for personal returns last Saturday 11/18 and this until about mid-January (they only indicate the reopening date a few days before). Unless you received an IRS notice and need to amend a return and attach it to your response, if you need to file a return, I would suggest to wait January in order to e-file. However money owed, interest and penalties keep running, so it is best to pay earlier than later, and this can be done independently of filing the return

I will be happy to see you early next year at my new office on the 4th floor of the Wells Fargo building at Hampden and Sheridan. Address is: 5353 W Dartmouth Ave, Ste 400, Denver, CO 80227

Reminders for 2023

If you are self-employed, the deadline for the 4th 2023 quarter estimated payment is January 16, 2024. Even if you did not make previous estimated payments, this last estimated payment will in general greatly reduce penalties, as long as the total money paid for 2023 is near your tax liability for the year. You can make this payment by sending a 1040-ES voucher with a check, or pay online on irs.gov (as an estimated payment for 2023). If you are filing jointly and paying online, I recommend making the payment at the primary name (first name on tax return) and SS.

- If you bought an electric car or installed solar panels on your house in 2023, please bring me paid invoices at tax time, so you get the tax credit on your return.

Proposition HH, Property Tax

So proposition HH was defeated on November 7 by Colorado voters (61% against)
It would have allowed for a reduction of property taxes over the next few years, but in exchange for the state to be able to use a portion of the excess money received for school programs, that otherwise the state is not allowed to do, as the Tabor amendment states that excess state revenues must be paid back to Colorado residents.

Proposition H, a complex compromise by lawmakers, (detailed in the blue book we received this summer) was hard to fully understand. Spending about an hour on it, it seemed to me that for homeowners, and in in general, the reduction in their property tax would be higher than the reduction of their Tabor refund. A client who is good with numbers figured the opposite. So the results would have been far from obvious for most of us. A majority of voters clearly said no to this unwanted complexity and to reducing the Tabor refunds.

So where does this leave us?
At this point the property taxes to be paid in 2024 for 2023 will be between 30% and 60% higher than in 2023 for most homeowners (average 42%). Basically, everybody agrees that it is too much an increase, and it is likely that the lawmakers will try to agree on and pass a simple measure, reducing somewhat the property tax to be paid in 2024.

We will see a large Tabor refund in 2024. Some of it will probably be figured in the Colorado 2023 tax return through a formula, but there could also be a later refund issued as a check when Colorado figures how much excess is left to refund. Although we don't know for sure, I would suggest that if you are not required to file, you may still want file a federal and state return to be sure to get this Tabor refund (in previous years Colorado made the refund conditional to having filed a tax return)

Rentals

Although in a majority of cases, reporting rentals in a tax return is relatively simple, tax law for rentals is complex and intricated. If you have a less than standard situation, it is likely it could be reported somewhat differently depending on the tax preparer.

You have chosen to have your returns prepared by a tax professional who is to understand and apply the tax law, so it is up to you if you like to read the below and get some understanding of what the law makers had in mind. However if you have a rental /rentals, it may be worth reading it. It gets more complex as it goes.

I still remember teaching a tax class on passive income to starting H&R Block tax pros a few years ago and, checking the material as it was presented in the course, and wondering how anybody starting in tax could make sense of it. So I chose then to present it differently, trying to show to the students the intent and logic of the law, more than the confusing set of rules. Below and in a summarized way are the main aspects of the tax law, trying to convey the intent and the logic of it, and not covering all the details. This heavy summarizing may mean a few inaccuracies and omissions in less than simple cases.

1/ The basics

Rentals are reported on schedule E, which is an income statement: revenue less expenses. An important part of part of the expenses is the depreciation, residential rentals buildings are depreciated on a 27.5 year straight line. So if one bought a rental with no land (land does not depreciate) for $275,000 28 years ago, it would be fully depreciated.

Rentals, largely due to the depreciation expense, and unless no mortgage (so no interest expense) on them, usually do not show a large income and often can show a loss, with its tax treatment explained below. A rule of thumb (and an election to take on the return) and although there are other rules to take into consideration, is that any single work on the rental under $2,500 can be expensed and above usually needs to be capitalized and depreciated with various depreciation times.

One of the very few simple rules that I will mention right away is that renting out a house for less than 15 days is not taxable income and does not need to be reported, but should if a 1099 is received (as IRS gets it and taxpayer would likely receive a notice later if not reporting it) There are a couple of ways to do it in the return, showing no net income. I would not claim a loss on a less than 15 days rental.

2/ ***"Passive activity"***

Wealthy and high-income people were able in the past to easily generate tax losses from rentals to reduce their taxes. The lawmakers decided in the 80s to limit this, and they came up with the following:

- As a general rule, rentals were categorized as a "passive activity" category (this is confusing as "passive activity" does not include interest, dividends, capital gains on investments which is portfolio income).
- Rentals managed by others (real estate management companies) with no landlord participation are a full passive activity. Passive losses can <u>only</u> apply against passive income and net losses are disallowed, but can be carried forward in their own passive category (which is different from capital losses and net operating loss).
- If "passive with active participation" usually meaning the owner collects the rent, call the repairmen, etc, but also can qualify if the owner oversees the management company and makes decisions like tenant choice and or repairs, a passive loss up to $25,000 per year is allowed (but read below!) The majority of simple single residential rentals falls in this category.
- For the above category the passive loss will be disallowed above a (not that high) income: the phase out starts at 100k Adjusted Gross Income (AGI) and the loss is fully disallowed at 150k (whether married filing jointly or single**!**), with a much lower AGI phaseout if married filing separately (the tax law hence restricting the spouse with the higher tax bracket to claim a rental loss…). The loss carrying forward applying as above.
- If a "real estate professional" then the activity is not considered passive, lawmakers decided it relates more to a business. There is no limitation of losses which can be used against other income. What is a real estate professional for the IRS? : answering a "safe harbor" rules, of which the two main elements are that more than half of the taxpayer activities are in real estate, and he/she spends more than 750 hours in real estate business and rentals in which he/she materially participates. An <u>active</u> licensed real estate broker managing his rental(s) him/herself would usually qualify.

- So the above is the tax law general set of rules for passive income. It has several implications and two main adds-on complications we will briefly look at below.

3/ adds-on

Two main things happened in recent years adding to the above:

- First, starting in 2018, corporations tax rate was largely reduced (basically from 35% to 21%) and the lawmakers, to make things equal, gave a 20% income deduction to self employed and pass-thru income: the "Qualified Business Income" (QBI). One question became: when and should this be applied to rentals? Or: at which point can a rental activity be considered a "trade or business"?
  The IRS came up with another safe harbor (for QBI), the main elements of which are that detailed books (with defined elements) need to be kept for each rental, and that at least 250 hours per year of rental services are performed. Practically this is to the appreciation of the tax preparer and some are more aggressive than others.
  In my opinion, most people who have 1, 2 or even 3 rentals do not qualify for the QBI deduction. What I do in border line situations is send to my client the full text of the safe harbor and ask: do you do all this? If a yes answer, I will apply the QBI deduction.
- Second, in recent years and with Airbnb, short-term rentals became much more prevalent. Again the question become : is a short term rental a business or a passive

rental? Although theoretically for the IRS a short-term rental, especially if extra services are provided (compared to a regular long-term rental) is more a business (and so a schedule C with self-employment income), it is often reported as a rental schedule E in the tax returns. Theres is no “safe harbor” on this, and it is to the judgment of the tax preparer.

4/ when selling

Many rental owners not aware of the tax law get a bad tax surprise when selling their rental. What happens is that the deductible depreciation taken over the years reduces the basis of the rental and at sale increases the capital gain generated. An added element is that (because the depreciation deduction applied in most case to income taxed at ordinary tax rates), the lawmakers decided that this part of the capital gain would be taxed at a higher tax rate: 25%

So in our example above: a rental bought 275k and fully depreciated after 27.5 years of rental, if this rental was sold for say 700k (which would only be an average appreciation of 3.5% per year), the capital gain would be taxed the following way: [700k, less selling costs, less 275k] taxed at the capital gain rates: 15% and/or 20%, depending on the total taxable income on the return, then the 275k (called “unrecaptured section 1250 depreciation”) taxed at 25%. This would generate a much higher tax bill than people usually think: ignoring the selling costs, at least 132k of federal tax (plus the Colorado taxes). The mortgage situation has zero impact on the capital gain and taxes.

When selling, all the carryforward passive losses from the previous years (on any rental) can be used against the capital gain.

In the next newsletter we’ll look at 1031 exchanges, deferring the taxable capital gain.

5/ additional complications (the devil is in the details)

- Renting part of one’s home (example basement): generally, prorate indirect expenses by SF rented / SF home, and there may be direct expenses for the part rented out. If not rented all year this would involve a double proration.
- Vacation home: this is complex, basically the lawmakers decided that people who have a second home should not be able to claim a loss if renting it out as soon as they spend more than 14 days in it. Generally, prorate yearly indirect expenses by days rented out / total days of use (which is quite favorable: if rented out 1 month and lived in 1 month, one would prorate ½ of yearly expense). The remaining ½ mortgage interest and RE taxes could possibly be claimed as itemized deductions, if enough to itemize.
- Timeshares: it is seldom that a timeshare is rented out 15 days or more, so normally no reportable income (but no loss either). However many management companies issue a 1099, and if so we need to report it on the return, showing no net income.
- Renting to a relative at a much lower than market rate: this happens quite a bit, the relative often simply paying the mortgage, directly or not. The IRS says no: you cannot claim a loss in this situation: it is considered as a “not for profit” rental (not to be confused with a non-profit), not reported on schedule E, and with expenses equal at the maximum to the income (and no loss carryforward)

If you read this to the end, you can see this is not simple and I only looked at “regular” complications. After a certain point, the tax preparer has to take a reasonable position in his/her reporting.

Unless expenses reported are quite above usual (car mileage, repairs, ?, and nobody knows the IRS systems algorithms pulling a return out for audit), and as rentals normally do not generate high losses or income, they are not audited very often.

6/ in closing

So is a rental a good thing to have?

Above is only the tax treatment of it, and I would say there are certainly good points:

- Social Security benefits are low and should not be counted as the only retirement income, and owning one or more rental(s) is a good supplemental retirement income: the cash flow is normally positive (depreciation is only a tax paper deduction)
- it diversifies one’s investments: brick and mortar vs money investments / stock market / bonds
- it allows for possible life situations like children needing a home, temporarily or not, moving in for two years to get the home capital gain exclusion, a safety net.
- one may be handy and slowly remodeling a rental between tenants, sweat equity adding to its value.
- rental would be inherited at fair market value by beneficiaries at one’s death, which money wise is a very good deal for them.

Happy Thanksgiving to all!

Michael

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