PacificCPE

COURSE
31052C

Individual Income Tax: Income Part 2

Covering some of the more complex income categories on individual returns, this course walks through rental income and expense rules, vacation home limitations, retirement plan distributions, pension and annuity taxation, and rollover rules. It also addresses Social Security benefit taxation and a broad range of other income items including canceled debt, partnership and S corporation income, royalties, unemployment benefits, and recoveries. A practical resource for practitioners handling diverse client income situations.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the proper treatment of rental property income and expenses for tax purposes.
- Identify various requirements regarding retirement plan taxation.
- Recognize key taxation thresholds related to social security income.
- Identify the taxability of various types of other income.

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Chapter 1: RENTAL INCOME AND EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the proper treatment of rental property income and expenses for tax purposes.

I. INTRODUCTION

This chapter discusses rental income and expenses. It covers the following topics.

- Personal use of dwelling unit (including vacation home).
- Depreciation.
- Limits on rental losses.

II. RENTAL INCOME

In most cases, you must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. It is not limited to amounts you receive as normal rent payments.

When to report. If you are a cash basis taxpayer, report rental income on your return for the year you actually or constructively receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account. If you are an accrual basis taxpayer, you generally report income when you earn it, rather than when you receive it.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example

You sign a 10-year lease to rent your property. In the first year, you receive $9,600 for the first year's rent and $9,600 as rent for the last year of the lease. You must include $19,200 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, those payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See Rental Expenses, later, for more information.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See Personal Use of Dwelling Unit (Including Vacation Home), later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

III. RENTAL EXPENSES

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your rental income, is discussed later.

When to deduct. If you are a cash basis taxpayer, you generally deduct your rental expenses in the year you pay them. If you are an accrual basis taxpayer, you generally deduct your expenses when you incur them, rather than when you pay them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Vacant while listed for sale. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold. If the property is not held out and available for rent while listed for sale, the expenses are not deductible rental expenses.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See Personal Use of Dwelling Unit (Including Vacation Home), later.

Part interest. If you own a part interest in rental property, you can deduct expenses that you paid according to your percentage of ownership.

Uncollected rent. If you are a cash basis taxpayer, you do not deduct uncollected rent. Because you do not include it in your income, it is not deductible.

Depreciation. You can begin to depreciate rental property when it is ready and available for rent. See **Placed-in-Service Date** under Depreciation, later.

REPAIRS AND IMPROVEMENTS

Generally, an expense for repairing or maintaining your rental property may be deducted if you are not required to capitalize the expense.

Improvements. You must capitalize any expense you pay to improve your rental property. An expense is for an improvement if it results in a betterment to your property, restores your property, or adapts your property to a new or different use.

Betterments. Expenses that may result in a betterment to your property include expenses for fixing a pre-existing defect or condition, enlarging or expanding your property, or increasing the capacity, strength, or quality of your property.

Restoration. Expenses that may be for restoration include expenses for replacing a substantial structural part of your property, repairing damage to your property after

you properly adjusted the basis of your property as a result of a casualty loss, or rebuilding your property to a like-new condition.

Adaptation. Expenses that may be for adaptation include expenses for altering your property to a use that is not consistent with the intended ordinary use of your property when you began renting the property.

Safe harbor for routine maintenance. If you determine that your cost was for an improvement to a building or equipment, you still may be able to deduct your cost under the routine maintenance safe harbor.

Note

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property. The expenses you capitalize for improving your property generally can be depreciated as if the improvement were separate property.

Safe Harbors under the IRS Regulations

The final regulations provide for three safe harbors related to improvements. They are a de minimis safe harbor, a safe harbor for small taxpayers, and a safe harbor for routine maintenance. If a safe harbor applies, a current deduction is allowed. The de minimis and small taxpayer safe harbors are annual elections made on a statement to be attached to the return, and not a change in accounting method.

De minimis safe harbor. This safe harbor allows you to elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted by you for financial accounting purposes or in keeping your books and records. If you have an applicable financial statement (AFS), you may use this safe harbor to deduct amounts paid for tangible property up to $5,000 per invoice or item (as substantiated by invoice). If you do not have an AFS, you may use the safe harbor to deduct amounts up to $2,500 per invoice or item (as substantiated by invoice). The de minimis safe harbor does not include amounts paid for inventory and land.

Small taxpayer safe harbor. This safe harbor allows small taxpayers to not capitalize an improvement, and therefore to deduct such costs of work performed on owned or leased buildings. In order to qualify, the requirements for small taxpayers are:

- Average annual gross receipts of $10 million or less; and

- Owns or leases building property with an unadjusted basis of $1 million or less; and
- The total amount paid during the taxable year for repairs, maintenance, improvements, or similar activities performed on such building property does not exceed the lesser of (1) two percent of the unadjusted basis of the eligible building property, or (2) $10,000.

Routine maintenance safe harbor. This safe harbor allows you to deduct expenses if the amounts meet all of the following criteria:

- Amounts paid for recurring activities that you expect to perform;
- As a result of your use of the property in your trade or business;
- To keep the property in its ordinarily efficient operating condition; and
- You reasonably expect, at the time the property is placed in service, to perform the activities (1) for building structures and building systems, more than once during the 10- year period beginning when placed in service, or (2) for property other than buildings, more than once during the class life of the unit of property.

The routine maintenance safe harbor does not apply to amounts paid for betterments, but does apply to certain restorations that would otherwise be improvements, including when you pay amounts to replace a major component or substantial structural part of a unit of property.

OTHER EXPENSES

Other expenses you can deduct from your rental income include advertising, cleaning and maintenance, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses, discussed next.

Rental of property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums paid in advance. If you pay an insurance premium for more than one year in advance, you cannot deduct the total premium in the year you pay it.