How to turn rental real estate activity losses into tax benefits
If you lose money on rental properties and try to deduct your losses, you may find that the IRS's passive activity loss rules are restrictive. However, if you can qualify as a "real estate professional," you can convert passive losses into nonpassive losses. Here's how.
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Get faster write-offs with a cost segregation study
Cost segregation studies can help business owners accelerate depreciation deductions on their properties — resulting in substantial current tax savings. How do these studies work, when do depreciation rules apply and what are their limits?
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Why the young and affluent need a different estate plan
How can young, affluent people plan their estates when the tax landscape may look dramatically different 30 or 40 years from now? They may want to consider a flexible trust that can reduce income and estate tax — whatever future tax laws might bring.
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Kiddie tax strategies for adults
"Kiddie tax" rules limit parents' ability to shift income to their children under age 19 (or under age 24 in certain circumstances) to save taxes, but there still are some opportunities available. You just have to know where to look.
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How to turn rental real estate activity losses into tax benefits

Let's say you own a few rental properties but, unfortunately, they're hemorrhaging money. You'd like to deduct your losses, but the passive activity loss (PAL) rules won't let you. It's probably worth your while to determine whether you fall under the IRS definition of a "real estate professional." If you qualify, you can enjoy tax benefits by converting passive losses into nonpassive losses.

What does "passive" activity mean?

The PAL rules prohibit taxpayers from currently deducting net losses generated by "passive" business activities — such as owning rental real estate — from wages, interest, dividends or other "nonpassive" income. Unallowed losses may be carried forward and deducted against passive income in later years or recovered when the taxpayer disposes of the passive activity.

A passive activity is a trade or business in which you don't "materially participate." "Participation" generally means work done by an individual with respect to the activity that the individual avoids an interest in. Participation doesn't include work that isn't customarily done by an owner if one of the principal purposes for performing the work is to avoid the PAL rules.

What about "material"?

"Material" means "regular, continuous and substantial," but that definition doesn't provide much guidance. Fortunately, IRS regulations establish several objective tests you can apply to determine whether an activity qualifies. Your participation in an activity is material if any one of the following is true during a tax year:

- You participate in the activity for at least 500 hours.
- You participate substantially all of the participation in the activity by all persons (including nonowners) — in other words, it's a one-person operation.
- You participate in the activity for at least 100 hours and no other person (including nonowners) participates more than you.
- You participate in the activity for at least 100 hours and your total participation in "100-hour" activities totals more than 500 hours.
- You materially participated in the activity for any five of the preceding 10 tax years (or any three previous tax years for a personal service activity).

Even if you don't satisfy one of these tests, you can meet the material participation requirement if, based on all the facts and circumstances, you participate in an activity on a regular, continuous and substantial basis. There's an added catch when it comes to real estate, however: The PAL rules treat income from rental real estate as passive, no matter how many hours you devote to it, unless you qualify as a "real estate professional."

How do you qualify as a "professional"?

Because you may be able to avoid the PAL limitations and deduct rental real estate losses from nonpassive income if you're a real estate professional, it's important to determine whether you qualify. To do so, you must spend more than half of your working hours and more than 750 hours during the year on real estate businesses in which you materially participate.

Activities you perform as an employee don't count toward these participation requirements unless you own at least 5% of the business. Eligible businesses include real property development, redevelopers, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage. Unlike the material participation requirements, you and your spouse can combine your hours; one of you must individually qualify as a real estate professional.

Even if you're a real estate professional, you must still materially participate in a rental activity before you can deduct losses against nonpassive income. This can be a problem if you're involved with several properties.

Suppose, for example, that you own 10 rental buildings and devote 80 hours per year per building to managing them, for a total of 800 hours per year. You also have two full-time employees who help manage the buildings. Assuming the 800 hours you spent in the last year constitute more than half of your working time, you would qualify as a real estate professional. But because you spent less than 100 hours on each building, you don't meet the material participation requirements.

You can get around this restriction — and convert your rental losses from passive to nonpassive. Simply elect on your tax return to treat all of your rental properties as a single activity.

Worth your time

Real estate professionals can treat rental real estate losses as nonpassive losses and deduct them from their wages or other nonpassive income. If your rental property is losing money and you'd benefit from taking the loss, look into whether you qualify for the "professional" designation.

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Get faster write-offs with a cost segregation study

For years, many business owners have taken advantage of cost segregation studies to help them accelerate depreciation deductions on their properties. These studies identify property components and their costs, which can enable you to use shorter lives and faster depreciation rates. The bottom line: You’ll likely see a substantial savings on your tax bill.

Maximizing current deductions

Real estate can be segregated into four categories of property: 1) buildings, 2) land, 3) land improvements, and 4) personal property.

Buildings generally are depreciated over 27.5 years (residential rental) or 20 years (commercial) using the straight-line method. This recovery period applies to real property, which includes buildings as well as structural components such as walls, concrete floors, paint windows, ceilings and HVAC systems.

Land is not depreciable. But you can typically depreciate land improvements over 15 years using 150% of the straight-line rate on the declining balance, and most personal property over five or seven years using 200% of the straight-line rate. Often, however, these property components are misclassified.

A cost segregation study identifies property components and their cost, allowing you to maximize current depreciation deductions by using the shorter lives and faster depreciation rates available for the qualifying parts of the property. For example, if $500,000 of assets were reclassified as seven-year vs. 29-year property, depreciation deductions in the first year, assuming the building was placed in service about midway, would increase from around $5,000 to more than $57,000.

Depreciation rules

There are no hard-and-fast rules for distinguishing personal property eligible for accelerated depreciation from structural components that are depreciated as part of a building. Various factors come into play, including how the property is affixed to the building, whether it’s designed to remain in place permanently, and how difficult it would be to move or remove.

Examples of personal property that can qualify for a faster depreciation deduction include:

- Decorative fixtures,
- Cabinets and shelves,
- Movable wall partitions, and
- Carpeting.

Certain plumbing, wiring, and heating and air conditioning vents and lines — which you’d normally think of as part of the building — may be eligible for shorter lives if they’re specifically required for equipment that has a shorter life (such as wiring for certain specialized equipment).

You can also depreciate the allocated portion of certain capitalized indirect or overhead costs — such as architectural and engineering fees. And land improvements that you can isolate with a cost segregation study include parking lots, sidewalks, fences and landscaping.

Understand the limits

A cost segregation study should be considered when you buy, build or remodel — or when you have done so within the last few years. But understand that the overall benefit of a cost segregation study may be limited in certain circumstances, such as when a business is subject to the alternative minimum tax (AMT) or is located in a state that doesn’t follow federal depreciation rules. Passive activity loss rules can also defer benefits.

The cost of a study generally pays for itself if the building or remodeling expenditures are fairly substantial and fairly recent. Also, if you perform a cost segregation study, you may be able to qualify for an automatic accounting method change — a fairly simple procedure.

Many variables

Cost segregation studies can be an excellent means for gaining faster write-offs on your real estate and construction projects. But be aware that such studies involve a lot of variables. So ask your tax advisor to help you determine whether you’re likely to benefit.

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Why the young and affluent need a different estate plan

Planning for income and estate taxes even 10 years from now can be challenging. But for young, affluent people who normally wouldn’t think about estate planning for another 20, 30 or 40 years, when the tax landscape is likely to be dramatically different, such plans may seem futile. Fortunately, there’s a tool that enables you to hedge your bets.

Conflicting strategies

Many traditional estate planning techniques evolved during a time when the gift and estate tax exemption was relatively low and the top estate tax rate was substantially higher than the top income tax rate. Under these circumstances, it usually made sense to remove assets from the estate early — through various trust and gifting strategies — to avoid future asset appreciation from estate taxes. Such lifetime asset transfers could result in higher income taxes for heirs, but in most cases, the estate tax benefits outweighed the income tax disadvantages.

Today, the exemption amount is $5.43 million and the top gift and estate tax rate (40%) is roughly the same as the top income tax rate (39.6%). If your estate’s worth is within the exemption amount, estate tax isn’t a concern and there’s no gift and estate tax benefit to making lifetime gifts.

But there’s a big income tax advantage to keeping assets in your estate: The basis of assets transferred at your death is stepped up to their current fair market value, so beneficiaries can turn around and sell them without generating capital gains tax liability. Assets you transfer by gift, however, retain your basis, so beneficiaries who sell appreciated assets face a significant tax bill.

Unpredictable future

For young adults, designing an estate plan is a challenge because it’s difficult to predict what the estate and income tax laws will look like — and what their own net worth will be — decades from now. If you believe that the value of your estate will remain lower than the exemption amount, then it may make sense to hold on to your assets and transfer them at death so your children or other heirs can enjoy the income tax benefits of a stepped-up basis.

But what if your wealth grows beyond the exemption amount so that estate taxes become a concern again? What if Congress decides to reduce the exemption amount? If that happens, removing assets from your estate as early as possible is the better tax strategy. However, by the time circumstances have changed, it may be too late to adopt that strategy.

Building flexibility

A carefully designed trust can make it possible to remove assets from your estate now, while giving the trustee the authority to force the assets back into your estate if that turns out to be the better strategy. This allows you to shield decades of appreciation from estate tax while retaining the option to include the assets in your estate should income tax savings become a priority.

For the technique to work, the trust must be irrevocable, you (the grantor) must retain no control over the trust assets (including the ability to remove and replace the trustee) and your trustee should have absolute discretion over distributions. In the event that estate inclusion becomes desirable, your trustee should have the authority to cause such inclusion by, for example, naming you as successor trustee or giving you a general power of appointment over the trust assets.

In determining whether to exercise this option, your trustee should consider several factors. This includes potential estate tax liability, the beneficiaries’ potential liability for federal and state capital gains taxes, and whether the beneficiaries plan to sell or hold onto the assets.

Consider the risk

Although an irrevocable trust offers welcome flexibility, it’s not risk-free. If you die unexpectedly, you may lose the opportunity to include the trust assets in your estate. Be sure to consider such risk as you determine whether this type of trust — or possibly other estate planning tools — will best address your situation.
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Kiddie tax strategies for adults

Some children who receive investment income are required to file a tax return and pay tax on at least a portion of that income — possibly at the parents' marginal tax rate, which is likely higher than the child's rate. This is often referred to as the "kiddie tax."

Because of the kiddie tax, shifting investment income to young children by transferring income-producing or appreciated assets to them will do little to reduce your own tax liability, however, if you have adult children in a lower tax bracket, opportunities remain to limit taxes. And if you own a business, you may be able to save taxes by employing your children — even if they're not adults.

Know the limits

The kiddie tax applies to children under age 19 or who are full-time students under age 24. The tax doesn't, however, apply if these children are married and file jointly or are dependent (that is, their earned income provides more than half of their support).

For 2015, a child's first $1,050 of investment income is tax-free. Therefore $1,050 is taxed at the child's rate and any excess over $2,100 is subject to the kiddie tax. Capital gains, dividends and interest from assets such as stocks, bonds and mutual funds are included.  

Spot the opportunities

Although shifting investment income to younger children will provide you with some tax advantages, shifting it to an adult child who isn't subject to the kiddie tax but is in a lower tax bracket can be much more beneficial. This is particularly true if you're subject to the top long-term capital gains rate of 20% and your son or daughter qualifies for the 0% rate. If you transfer highly appreciated assets, your child could sell them and potentially pay 0% tax on the appreciation. And remember that the long-term capital gains rate also applies to qualified dividends.

Shifting income can also reduce your liability for the 3.8% net investment income tax (NIT). See the sidebar at right, "What about the NIT?"

Before transferring assets to children, be sure to also consider the gift tax consequences. Gifts up to $14,000 per recipient ($28,000 if you and your spouse "split" the gift) in 2015 are gift-tax-free under the annual exclusion. But gifts in excess of that amount generally will affect use part of your lifetime gift tax exemption or be subject to gift tax.

Pay your children

Just because your children are young enough to be subject to the kiddie tax doesn't mean you don't have income-shifting opportunities. If you own a business, you may be able to shift income to your children through that business without triggering the kiddie tax. Paying your children reasonable compensation for work performed provides a double benefit — earned income for the child and a business tax deduction.

Because Uncle Sam taxes the child's earned income at the child's likely lower tax rate, that income effectively avoids the kiddie tax. Depending on the structure of your business, FICA and FUTA tax exemptions may also apply to the child's wages.

Another advantage of paying your child is that the child will almost assuredly be eligible for an IRA contribution. Opting for a traditional IRA will provide a current tax deduction, thereby sheltering income.

With a Roth IRA, there won't be a current deduction on the child's tax return, but the future tax-free distributions may make the Roth IRA the preferred choice. And if the child's income doesn't exceed the standard deduction ($6,300 for singles in 2015), the deduction for a traditional IRA contribution won't provide a tax benefit. So there isn't a tax downside to making a Roth rather than traditional contribution.

A proper plan

Kiddie tax rules may limit the amount of tax savings you can enjoy from income-shifting, but with proper planning, you — as well as your business — can realize adult-size benefits. Talk to your tax advisor about which strategies might be appropriate in your circumstances.

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Is this item worthy of implementation? [ ] Yes  [ ] No  [ ] Maybe

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