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If You Took Out a PPP Loan, Plan on it Being Forgiven

Many small businesses took advantage of the PPP loans that were offered by the government in the face of the COVID-19 crisis. While these loans were attractive because they are forgivable and gave businesses a chance to survive the dire circumstances, in April of 2020 the IRS issued Notice 2020-32, which indicated that despite the fact that the forgivable loans can be excluded from gross income, the expenses associated with the moneys received cannot be deducted. This effectively erases the tax benefit initially offered because losing the employee and expense deduction increases the business' income and profitability.

There is some chance that this issue will be resolved by Congress, as it clearly contradicts the original intent of the tax benefit that accompanied the PPP funds, but that action has not yet been taken. It's a good idea to talk to our office about this as soon as possible, as having to pay taxes on expenses incurred may be particularly challenging in the face of the difficulties the pandemic has imposed. Being financially prepared to pay more taxes than you originally intended may be a bitter pill to swallow but will still be better than having to pay penalties and interest if you fail to pay what the government says that you owe.

Renting Your Home or Vacation Home for Short Periods

Many taxpayers rent out their first or second homes without considering tax consequences. Some of these rules can be beneficial, while others can be very detrimental. If you rent your home to others, then you should be aware of some special tax rules that probably apply to you.

Even if you rent out your property using rental agents or online rental services that match property owners with prospective renters (such as Airbnb, VRBO or HomeAway), it is still your responsibility to properly report the rental income and expenses on your tax return.

Special (and sometimes complex) taxation rules can make the rents that you charge tax-free. However, other situations may force your rental income and expenses to be treated as a business reported on Schedule C, as opposed to a rental activity reported on Schedule E.

The following is a synopsis of the rules governing short-term rentals.

Rented for Fewer than 15 Days During the Year – When a property is rented for fewer than 15 days during the tax year, the rental income is not reportable, and the expenses associated with that rental are not deductible. Interest and property taxes are not prorated, and the full

amounts of the qualified mortgage interest and property taxes are reported as itemized deductions (as usual) on the taxpayer’s Schedule A.

The 7-Day and 30-Day Rules – Rentals are generally passive activities, which means that losses from these activities are generally only deductible up to the amount of gains from other passive activities. However, an activity is not treated as a rental if either of these statements applies:

1. The **average** customer use of the property is for 7 days or fewer—or for 30 days or fewer if the owner (or someone on the owner’s behalf) provides significant personal services.
2. The owner (or someone on the owner’s behalf) provides extraordinary personal services without regard to the property’s average period of customer use.

If the activity is not treated as a rental, then it will be treated as a trade or business, and the income and expenses, including prorated mortgage interest and real property taxes, will be reported on Schedule C. IRS Publication 527 states: “If you provide substantial services that are primarily for your tenant’s convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C.” Substantial services do not include the furnishing of heat and light, the cleaning of public areas, the collecting of trash, or other such general amenities.

Exception to the 30-Day Rule – If the personal services provided are similar to those that generally are provided in connection with long-term rentals of high-grade commercial or residential real property (such as public area cleaning and trash collection), and if the rental also includes maid and linen services that cost less than 10% of the rental fee, then the personal services are neither significant nor extraordinary for the purposes of the 30-day rule.

Profits and Losses on Schedule C – Typically, if you own and operate a business that isn’t set up as a corporation, the income and expenses of your business would be reported on Schedule C as part of your income tax return, and you would pay self-employment tax (Social Security and Medicare taxes), as well as income tax, on the profit. However, if you have a profit from a rental activity, it is not subject to self-employment tax even when reported as self-employment income unless you are a real estate dealer. If you have a loss from this type of activity, it is still treated as a passive activity loss unless you meet a material participation test—generally by providing 500 or more hours of personal services during the year related to the rental or qualifying as a real estate professional. Losses from passive activities are deductible only up to the passive income amount, but unused losses can be carried forward to future years. A special allowance for real estate rental activities with active participation permits a loss against nonpassive income of up to $25,000. This phases out when modified adjusted gross income is between $100K and $150K. However, this allowance does **NOT** apply when the activity is reported on Schedule C.

These rules can be complicated; please call this office to determine how they apply to your particular circumstances and what actions you can take to minimize tax liability and maximize tax benefits from your rental activities.

Don’t Miss the Opportunity for a Spousal IRA

One frequently overlooked tax benefit is the spousal IRA. Generally, IRA contributions are only allowed for taxpayers who have compensation (the term “compensation” includes wages, tips, bonuses, professional fees, commissions, taxable alimony received, and net income from self-employment). Spousal IRAs are the exception to that rule and allow a non-working or low-earning spouse to contribute to his or her own IRA, otherwise known as a spousal IRA, as long as the spouse has adequate compensation.

The maximum amount that a non-working or low-earning spouse can contribute is the same as the limit for a working spouse, which is $6,000 for 2020. If the non-working spouse’s age is 50 or older, that spouse can also make “catch-up” contributions (limited to $1,000), raising the

overall contribution limit to $7,000. These limits apply provided that the couple together has compensation equal to or greater than their combined IRA contributions.

- ***Example:*** *Tony is employed and his W-2 for 2020 is $100,000. His wife, Rosa, age 45, has a small income from a part-time job totaling $900. Since her own compensation is less than the contribution limit for the year, she can base her contribution on their combined compensation of $100,900. Thus, Rosa can contribute up to $6,000 to an IRA for 2020.*

The contributions for both spouses can be made either to a traditional or Roth IRA, or split between them as long as the combined contributions don't exceed the annual contribution limit. **Caution:** The deductibility of the traditional IRA and the ability to make a Roth IRA contribution are generally based on the taxpayer's income:

- **Traditional IRAs** – There is no income limit restricting contributions to a traditional IRA. However, if the working spouse is an active participant in any other qualified retirement plan, a tax-deductible contribution can be made to the IRA of the non-participant spouse only if the couple's adjusted gross income (AGI) doesn't exceed $196,000 in 2020 (up from $193,000 in 2019).

- **Roth IRAs** – Roth IRA contributions are never tax deductible. Contributions to Roth IRAs are allowed in full if the couple's AGI doesn't exceed $196,000 in 2020 (up from $193,000 in 2019). The contribution is ratably phased out for AGIs between $196,000 and $206,000 (up from a range of $193,000 to $203,000 in 2019). Thus, no contribution is allowed to a Roth IRA once the AGI exceeds $206,000.

    - ***Example:*** *Rosa from the previous example can designate her IRA contribution as either a deductible traditional IRA or a nondeductible Roth IRA because the couple's AGI is under $196,000. Had the couple's AGI been 201,000, Rosa's allowable contribution to a deductible traditional or Roth IRA would have been limited to $3,000 because of the phase-out. The other $3,000 could have been contributed to a traditional IRA and designated as nondeductible.*

Please give this office a call if you would like to discuss IRAs or need assistance with your retirement planning.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

Scott Jensen
Kramer & Jensen, LLC

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