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Tax Issues That Arise When Converting a Home into a Rental

With the current substantial appreciation in home values and demand for housing exceeding the available inventory, along with low home mortgage interest rates, more and more homeowners are converting their existing homes into rentals when they buy a new home. Other reasons individuals may make the conversion include maximizing the tax benefits for an elderly person who can no longer live alone by delaying the sale of that person's home; and to ensure that a home provides value when its owner takes a temporary job assignment in a different location. Some homeowners even mistakenly think that, when a home has declined in value, converting it into a rental can allow them to deduct that loss. Regardless of why an individual considers making a conversion, several tax matters come into play when making that decision.

Basis – The basis of the converted property is a good place to start examining these conversion-related tax issues. The basis is the starting value that is used to calculate gains or losses for tax purposes. The basis is also used to determine the amount of depreciation that can be claimed for property used in the rental activity. Generally, for depreciation purposes, a property's depreciable basis on the date of the conversion is the lower of its adjusted basis (the original cost, plus the costs of any improvements, minus any deducted casualty losses) or its fair market value (FMV).

Depreciation – Depreciation is an allowance that both accounts for wear and tear and provides a systematic way for the owner to recover the initial investment in the property. This is necessary because tax law doesn't allow homeowners to deduct the entire cost of a residential rental at one time. Despite this statutory allowance for the depreciation of residential rentals, real properties have historically appreciated rather than depreciated, so this allowance typically provides a significant tax advantage (i.e., a write-off). Here is how to determine the depreciation for a residential rental: First, reduce the basis by the value of the surrounding land (as land is not depreciable) to get the value of the improvements to the home (i.e., the structure); then, multiply that value by .03636 (the annual depreciation rate). In the conversion year, the resulting amount has to be prorated by the number of months used as a rental. Generally, the value of the land is based on a property-tax statement. For example, if a property-tax statement values an entire property at $240,000 and its land at $80,000, then 1/3 of the basis ($80,000 / $240,000) is allocated to land; the remaining 2/3 is allocated to improvements. Thus, if the basis is $300,000, then the depreciable improvements are valued at $200,000 (2/3 × $300,000), and the annual depreciation deduction is $7,272 (.03636 × $200,000).

Rental Cash Flow versus Taxable Profit or Loss – Cash flow is the net amount after subtracting expenses from rental income, and the taxable profit or loss is the rental income minus any allowable tax deductions. Of course, higher cash flow is always better, but it is particularly important to avoid having a rental with a negative cash flow. The following example compares cash flow to taxable income.

COMPARISON OF CASH FLOW AND TAXABLE INCOME		
Income/Expense	Cash Flow($)	Taxable Income($)
Rental Income	**30,000**	**30,000**
Mortgage Payment	<23,000>	-
Mortgage Interest	-	<20,700>
Real Property Tax	<2,400>	<2,400>
Insurance	<1,800>	<1,800>
Maintenance & Repairs	<400>	<400>
Gardening	<800>	<800>
Depreciation	-	<7,272>
Total Expenses	**<28,400>**	**<33,372>**
Cash Flow	**1,600**	-
Taxable Income	-	**(3372>**

The major difference between cash flow and taxable income is that cash flow includes the deduction for the entire mortgage payment (not just the interest) but does not include the deduction for depreciation. In the above example, the rental has $1,600 in positive cash flow for the year but also has a passive loss (tax write-off) of $3,372.

Passive Losses – Losses from residential rental real estate are classified as passive and can only offset passive income; deductions from passive losses are also limited to $25,000 per year for most taxpayers with adjusted gross incomes (AGIs) of $100,000 or less. This limit is then ratably phased out for AGIs up to $150,000. Thus, taxpayers' ability to benefit from a tax write-off on a rental is dependent upon their AGIs. The good news is that the passive losses in excess of this limit carry over to future years and can be used to offset other passive income in those years; in addition, any unused carryforward amount and any passive losses in the sale year are deductible in full once the rental is sold.

Home Gain Exclusion – IRC Section 121 allows homeowners to exclude up to $250,000 of gains from a home sale if they owned and used that home (as their primary residence) for at least 2 of the 5 years prior to the sale date. The amount that can be excluded jumps to $500,000 for married couples who are filing jointly – provided that both have used the property as a primary residence for 2 out of the prior 5 years and at least one has owned the property for 2 out of the prior 5 years. This is a very important consideration because, once a home is converted into a rental, the homeowner(s) will lose the ability to exclude gains after 3 years (because at that point, it is no longer possible to meet the 2-out-of-5-years qualifications).

Even when a homeowner sells a rental property after its conversion but before the exclusion period expires, any depreciation that was claimed during the rental period must be recaptured as taxable income.

Other Tax Considerations – This article has covered only some of the tax issues affecting rental property. Others include the qualified business income deduction available for trade or business owners which generally include landlords, requirements to issue 1099 forms to service providers, and special rules for real estate professionals. If you have a "homeowner's exemption" on your home for real estate tax purposes, in most jurisdictions when you convert the home to a rental you will no longer be eligible for this exemption, so you should expect to pay higher property taxes.

Being a landlord will come with some challenges, such as repairs and maintenance, and of course, making sure you rent to responsible tenants. For those that do not wish to deal with landlord responsibilities, management firms are generally available for a fee, which counts as a rental expense for tax purposes.

The benefits of renting include cash income, tax write-offs, and most of all, long- term appreciation of the property. But not all circumstances warrant converting a home to a rental versus selling it. Please contact this office for assistance with the financial and tax aspects and the pros and cons of converting.

S Corporations Reasonable Compensation Requirement

Unlike a C corporation, which itself pays the tax on its taxable income, an S corporation does not directly pay taxes on its income; instead, its income, losses, deductions, and credits flow through to its shareholders' individual tax returns on a pro rata basis. These distributions are not subject to self-employment (Social Security and Medicare) taxes. As a result, many S corporations ignore the requirement that each shareholder-employee must take reasonable compensation in the form of W-2 wages in exchange for services performed for the corporation. These wages are subject to Social Security and Medicare taxes (which the corporation and the employee generally split equally); the corporation is also responsible for paying the Federal Unemployment Tax (as well as any state unemployment taxes).

The Internal Revenue Code establishes that an officer of an S corporation is an employee of that corporation for Federal Unemployment Tax purposes. S corporations should not attempt to avoid paying employment by treating their officers' or shareholder compensation as distributions rather than as wages.

This has been an issue for decades; in 1974, the IRS issued a ruling stating that, when a shareholder-employee fails to take a salary, or if that salary is unreasonable, an auditor should assert that the salary is unreasonable. The officer's distributions will then be shifted to account for reasonable compensation, and he or she will be assessed the related employment taxes and penalties. At stake here are the employee's 6.2% Social Security and 1.45% Medicare payroll taxes, the S corporation's matching amounts, the Federal Unemployment Tax, and whatever state taxes happen to apply.

Who Is an Employee of the Corporation? – Generally, an officer of a corporation is considered an employee of that corporation. The fact that an officer is also a shareholder does not change the requirement that any payments made to that officer must be treated as wages. Courts have consistently held that S corporation shareholders who provide more than minor services to their corporation (and receive payment in return) are employees whose compensation is subject to federal taxes.

What's a Reasonable Salary? – The instructions for Form 1120S ("U.S. Income Tax Return for an S Corporation") state: "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation." There are no specific guidelines in the tax code regarding the definition of reasonable compensation. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of the individual cases. These are some factors that courts have considered when determining reasonable compensation:

- The shareholder training and experience
- The shareholder duties and responsibilities
- The time and effort that the shareholder devotes to the business
- The company's dividend history
- The company's payments to non-shareholder employees
- The timing and manner of the bonuses paid to key people at the company
- The payments that comparable businesses have made for similar services
- The company's compensation agreements
- The formulas that similar company's have used to determine compensation

The problem here, of course, is that it is easy for the IRS to simply list contributing factors that courts have used when determining reasonable compensation and leave it to each S corporation to quantify these factors and determine a reasonable salary—all while retaining the ability to challenge the selected amount later if an auditor decides that the compensation is not reasonable. The IRS has a long history of examining S corporations' tax returns to ensure that reasonable compensation is being paid, particularly when a corporation pays no compensation to employee-owners.

199A Deduction Issue - A few years back Congress added a flow-through deduction (also referred to as the "199A deduction" after the section of the tax code that describes it). This deduction applies to S corporations (among many other business entities) and added another level of complexity to the determination of reasonable compensation.

- The wages of an S corporation's employee-owner are NOT treated as qualified business income (QBI) that is eligible for the individual's 199A deduction. However, the

S corporation deducts these wages as a business expense when it calculates the profit that passes through to the owner as QBI on Schedule K-1. Thus, larger wages mean less K-1 flow-through income (QBI) and thus a smaller 199A deduction (as that is equal to 20% of QBI). In these situations, S corporations tend to minimize owners' salaries to maximize flow-through income; this strategy increases the employee-stockholder's 199A deduction and lowers the payroll taxes for both the S corporation and the employee-owner.

- If married taxpayers who are filing a joint return in 2022 have 1040 taxable income that exceeds $340,100 (or $170,050 for those with other filing statuses), the 199A deduction begins to be subject to a wage limitation. Once the 1040 taxable income for married taxpayers filing jointly exceeds $440,100 (or $220,050 for those with other filing statuses), the wage limitation is fully phased in. In that event, the 199A deduction becomes the lesser of the wage limitation or 20% of the QBI; if the wage limitation is zero, there is no 199A deduction. These phasing amounts are inflation adjusted annually.

The wage limitation comprises the wages that the S corporation paid, including those paid to owners, plus the unadjusted cost of the qualified property that the s-corporation owned and used during the year. To be more specific, the wage limitation is the larger of

- 50% of the wages that the corporation paid to all its employees or
- 25% of the corporation's paid wages plus 2.5% of the unadjusted cost of its qualified property.

Thus, for those high-income owners for whom the wage limitation applies, if the S corporation pays no wages and has no qualified property, the owner will not have a 199A deduction.

If an S corporation is a specified service trade or business, the 199A deduction phases out; for married taxpayers who are filing a joint return, it phases out at taxable incomes between $340,100 and $440,100 (for those with other filing statuses, it phases out between $170,050 and $220,050). The IRS describes specified service trades or businesses as those in the fields of health, law, accounting, actuarial science, performing arts, athletics, consulting, financial services, and brokerage services, as well as those for which reputation and/or skill are contributing factors (for more details on what constitutes a specified service trade or business, please give this office a call).

Thus, if married taxpayers who are filing jointly for 2022 have taxable income more than $440,100 (or $220,050 for those with other filing statuses), they receive no benefit from the wage limitation; therefore, they also tend to minimize their reasonable compensation in order to minimize their FICA taxes.

Of course, taxpayers cannot pick and choose a particular level of reasonable compensation to minimize their taxes or maximize their deductions; therein lies a trap. Taxpayers instead should consider all the factors related to reasonable compensation. However, pulling all the data together to support such a determination can be difficult and time-consuming. Some commercial firms have the necessary data and resources to properly apply the various factors mentioned in this article to determine the proper level of reasonable compensation; this can provide backup in the case of an IRS challenge.

Please give this office a call if you have questions related to reasonable compensation for S corporation shareholders or how it impacts your specific tax situation.

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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