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Newsletter September 2023

2023 Due Dates

September 15 - Estimated Tax Payment Due

The third installment of 2022 individual estimated taxes is due.

September 15 - S Corporations

File a 2022 calendar year income tax return (Form 1120-S) and pay any tax due. This due date applies only if you requested an automatic 6-month extension. Provide each shareholder with a copy of their Schedule K-1 (Form 1120-S) or a substitute Schedule K-1 and, if applicable, Schedule K-3 (Form 1120-S) or substitute Schedule K-3 (Form 1120-S).

September 15 - Partnerships

File a 2022 calendar year return (Form 1065). This due date applies only if you were given an additional 5-month extension. Provide each partner with a copy of K-1 (Form 1065) or a substitute Schedule K-1.

September 30 - Fiduciaries of Estates and Trusts

File a 2022 calendar year return (Form 1041). This due date applies only if you were given an extension of 5 1/2 months. If applicable, provide each beneficiary with a copy of K-1 (Form 1041) or a substitute Schedule K-1.

October 16 - Individuals

If you have an automatic 6-month extension to file your income tax return for 2022, file Form 1040 and pay any tax, interest, and penalties due.

October 16 - Corporations

File a 2022 calendar year income tax return (Form 1120 or 1120-A) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic 6-month extension.

How Does Education Impact Your Taxes?

The kids are back in school! Things like student loans, scholarships, and fellowship grants can play a role in parents' and college students' tax liability. Let's look at how education costs can impact your taxes.

Student Loan Forgiveness

Student debt is a hot topic. As of July 2023, total U.S. student loan debt stood at $1.774 trillion while the average federal student loan balance was $37,717. The Supreme Court struck down President Biden's plan to provide blanket loan forgiveness to all student borrowers so he teamed with the Department of Education to announce a new proposal. The new rule expands on established law that provides debt relief for borrowers who made at least 240 or 300 monthly payments on their loan. The calculation now includes months where payments were late, partial, or deferred and helps those who have held student debt for a long time. We await a proposal to help more recent borrowers and those who stopped paying on their loans altogether.

IRS Publication 970: Tax Benefits of Education is a great resource regarding income, deductions, and credits.

Income

Scholarships and fellowship grants are not included in taxable income if certain conditions are met. The student must be a candidate for a degree at an eligible educational institution. The proceeds must be used for qualified expenses including tuition and fees, books, and other course-related expenses. They cannot be used for room and board, research, travel, and other expenses that aren't required for enrollment or attendance at the institution. Scholarships and fellowship grants are taxed as ordinary income if they do not meet the requirements.

Deduction

You can deduct student loan interest payments of up to $2,500 per return if certain conditions are met. This deduction phases out with modified adjusted gross income (MAGI) between $70,000 and $80,000 if single and $145,000 and $175,000 if filing jointly. If you qualify, you can take this deduction even if you don't itemize.

Credits

Education costs can generate an American Opportunity Tax Credit (AOTC) and/or a Lifetime Learning Credit (LLC). You can only claim one of these credits each year for each qualifying student but you can claim different credits for different students in the same year. They phase out with MAGI between $80,000 and $90,000 if single and $160,000 and $180,000 for joint filers.

The AOTC provides a credit of up to $2,500 for adjusted qualified education expenses paid for each eligible student. The AOTC is the sum of:

1. 100% of the first $2,000 of qualified education expenses you paid for the eligible student, and

2. 25% of the next $2,000 of these expenses.

Up to 40% of this credit or $1,000 is refundable. It's available for up to four years of study per eligible student who has not already completed four years of postsecondary education. To qualify, the student must be enrolled at least half-time for at least one academic period and must not have been convicted of a felony for possessing or distributing a controlled substance.

The LLC offers a credit of up to $2,000 per return. The LLC is 20% of the first $10,000 of qualified education expenses you paid for eligible students. Qualified expenses include tuition and fees required for enrollment or attendance as well as amounts required to be paid to the institution for course-related books, supplies, and equipment. You can claim the credit even if the student withdraws unless the payments are refunded. The LLC is nonrefundable so it can only offset tax liability. There is no limit to the number of years it can be claimed for each student and it can apply to courses taken to acquire or improve job skills. Generally, you must receive Form 1098-T from the institution to take the credit. If the institution isn't required to furnish it, you must be able to demonstrate that the student was enrolled at an eligible educational institution and substantiate your payment of qualified expenses. If the institution is required to provide it but you haven't received it, you can still take the credit if:

1. After January 31 but before you file your return, you ask the institution to provide it to you;

2. You fully cooperate with their efforts to gather the required information; and

3. You qualify for the benefit, can demonstrate that you were enrolled at an eligible institution, and you can substantiate the payment.

It turns out that a great education can pay off in life AND in taxes!

Tax Issues When Converting a Rental to Your Personal Residence

Deductions When a Rental Property Is Converted to a Personal Residence

Converting a rental property to a personal residence raises unique tax implications. If you own a home that you currently rent out and are thinking of converting the property to use as your personal residence, here are issues you should be considering.

On conversion, you can no longer deduct the same expenses – such as costs of utilities, home insurance and repairs – that were deductible when the property was a rental. However, the deductions for mortgage interest expense and property taxes will be available subject to limits and can be useful if your itemized deductions exceed the standard deduction. Even so, these home-related deductions may be limited, depending on the mortgage (loan) amount (for the interest deduction) and whether the overall state and local taxes you paid during the year exceeded $10,000 (for the property tax deduction). Some credits may also be available, such as those for installing a solar system or making energy-efficient home improvements.

The more complex impact of the conversion occurs when the property is sold. As a personal residence, some or all of the gain on the sale of the property, if any, can qualify for exclusion from income under certain conditions.

Loss on Sale of a Personal Residence

You cannot deduct a loss incurred on the sale of your personal residence as nonbusiness losses are not deductible.

Exclusion of Gain on Sale of Personal Residence – The Ownership and Use Tests

When certain conditions are met, a single taxpayer may be able to exclude from income up to $250,000 of the gain on the sale of a personal residence, while up to $500,000 of gain can be excluded on a joint return. The exclusion is allowed each time a taxpayer meets the eligibility requirements, but generally no more frequently than once every two years.

The general qualification for exclusion of gain on the sale of a personal residence is subject to two tests: (1) the ownership and (2) use tests.

The ownership test requires that you have owned the home for at least two of the five years leading up to the home's sale date.

The use test requires that you must have lived in the home as your main residence for at least two years during the 5-year period ending on the date of the sale. This period does not have to coincide with the two-year period that meets the ownership test. For example, you may have rented and lived in the property for two years then bought the property from the landlord. Then you may have rented the property out for the next two years before selling it. You would have satisfied the use test in the two years while renting the property from the previous owner. And you would have satisfied the ownership test in the two years before the sale while the property was rented out. Thus, the sale qualifies under the ownership and use tests.

If you are married, to be eligible for the $500,000 exclusion, either you or your spouse may have been the owner during the testing period, but both of you must meet the use test.

If you originally acquired the home via a tax-deferred exchange, then you (or your spouse, if married) must own the home for a minimum of five years before the home sale exclusion can be used, provided you (and your spouse, if married) also meet the 2-year use test.

Partial Exclusion of Gain

If the ownership and use tests are not met, the sale of a personal residence may still qualify for a partial exclusion of gain if the reason for the sale was work-related, health-related, or triggered by an unforeseen event. IRS Publication 523 provides details as to how each of these situations is determined.

The Impact of a Rental Period After 2008

A special rule enacted in 2008 requires the proration of gain on the sale of a personal residence that was initially used other than as a personal residence. The percentage of time that the property was used for a nonqualifying use (such as a rental) must be considered to determine the maximum gain exclusion for the property. For example, if a property was purchased after 2008 and rented for 2 years before it was converted to a personal residence, the gain exclusion amount must take those two years of nonqualifying use into account to determine the maximum gain exclusion available. If the property was sold after it was owned for 5 years, for example, then the maximum exclusion amount is 60% of the $250,000/$500,000 exclusion figures since the property was a personal residence for three of the five years it was owned.

Depreciation Recapture

The sale of a residence that has been converted from rental to personal use triggers the recapture of depreciation claimed during the time the property was used as a rental. This recapture is reported as ordinary income on the tax return for the year of the sale and is taxed at the taxpayer's highest tax rate up to a 25% cap.

Reporting the Sale

The sale or exchange of your primary residence is reported on Form 8949, Sale and Other Dispositions of Capital Assets, if:

- You have a gain and it is not fully excludable from income,
- You have a gain and choose not to exclude it, or
- You received a Form 1099-S, Proceeds from Real Estate Transactions. This form is prepared and issued to you, with a copy to the IRS, by the settlement agent, such as an escrow company or attorney.

Even if you didn't receive a Form 1099-S, and the gain is fully excludable, it may be prudent to report the sale on Form 8949 anyway so that there's an income tax record of the transaction.

If you are contemplating converting a rental to a personal residence, we can help you determine tax ramifications in advance. Please call for assistance.

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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