

## Converting a Residence to Rental Property

Recovering real estate values may cause some homeowners to consider converting their personal residence to rental property for investment purposes. The process for making this decision should include an analysis of economic factors, such as the homeowners' marginal tax rate and the potential loss of the ability to exclude up to \$250,000 (\$500,000, if married) of gain from the sale of their principal residence for federal income tax purposes.

Other economic factors to consider include the expected growth rate for rental property in the area, length of time the house will be rented before being sold, cash flow from renting, effect of passive activity rules (which limit and defer tax deductions), and expected rate of return available on other investments. Generally, the economic advantage of converting a personal residence to a rental rather than selling it is increased as the growth rate of the rental property increases and the rate of return on alternative investments decreases, but each situation should be thoroughly analyzed based on its particular facts and circumstances.

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If selling a personal residence would result in a nondeductible loss, the homeowner can seriously consider converting the residence to a rental property. Tax-saving opportunities generally are limited for residential rental conversions, primarily because of the passive activity loss rules. However, converting a personal residence into rental property may allow the homeowner to eventually recognize a loss for tax purposes on the property's subsequent sale if the property continues to decline in value, and thus provide cash flow in the interim.

The fact that a residence is rented at the time of the sale does not automatically preclude gain attributable to such use to be excluded under the gain exclusion rules. Instead, the exclusion of gain depends on whether the homeowner meets the ownership and use requirements and the one-sale-in-two-years test at the time of the sale.

The decision to convert a residence to rental or investment property is complex, and the ramifications of this decision are far-reaching. Please contact us to thoroughly explore the numerous tax and economic issues related to such a conversion.

## Coverdell Education Savings Accounts

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The Coverdell Education Savings Account (ESA) was created as an incentive to help parents and students save for education expenses. The total contributions for the beneficiary of this account cannot be more than \$2,000 in any year, no matter how many accounts have been established. A beneficiary is someone who is under age 18 or has special needs.

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax-free until distributed. The beneficiary will not owe tax on the distributions if they are used for qualified education expenses at an eligible institution. This benefit applies to qualified higher education expenses as well as to qualified elementary and secondary education expenses.

If there is a balance in the Coverdell ESA when the beneficiary reaches age 30 (unless the beneficiary is a special needs individual), it must generally be distributed within 30 days. The portion representing earnings on the account will be taxable and subject to the additional 10% tax. The beneficiary may avoid these taxes by rolling over the full balance to another Coverdell ESA for another family member.

## Making Your Hobby a Business

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Taxpayers often enjoy their hobby activity more than they do their job. In many cases, they invest a great deal of time and money, and some eventually make their hobby a full- or part-time business activity. Unfortunately, the IRS has a lot to say when it comes to the business vs. hobby decision. It's not a problem as long as the new business turns a profit. And it may be fine as well if the business produces a loss and the taxpayer enjoys the activity—even better if the loss can offset other income. However, if the business consistently generates losses, the IRS could determine that these losses are actually nondeductible hobby losses.

Many hobby loss issues center on the weekend farmer or rancher. However, the hobby loss rules are applicable to any type of activity in which the taxpayer might engage. In any case, to escape the hobby loss taint and avoid ending up with nondeductible losses, the activity must be conducted with the actual and honest intent of making a profit.

There are generally two ways to avoid the hobby loss rules. The first is to show a profit in at least three out of five consecutive years (two of seven years for activities involving horse racing, breeding, or showing). If the safe harbor is met, the burden of proof for lack of profit motive is shifted to the IRS. The second way is to run the venture in a manner that shows you intend to turn it into a profit-making business rather than operate it as a mere hobby. The IRS regulations themselves state that the hobby loss rules won't apply if the facts and circumstances show that you have a profit-making objective.

The best way to prove that you have a profit-making objective is to run the new venture in a businesslike manner. Specifically, the IRS and the courts will look to the following factors: how you run the activity; your expertise in the area (and your advisers' expertise); the time and effort you expend in the enterprise; whether there's an expectation that the assets used in the activity will rise in value; your success in carrying on other similar or dissimilar activities; your history of income or loss in the activity; the amount of occasional profits (if any) that are earned; your financial status; and whether the activity involves elements of personal pleasure or recreation.

In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are taken into account. No one factor is determinative. In addition, it is not intended that only the factors described above are to be considered in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa.

## Retirement Plan Review

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Your retirement plan savings (e.g., qualified plans and IRAs) are important to your financial well-being for many reasons. You can accumulate income without currently paying tax, and the power of compounding pretax dollars makes a retirement plan one of the most powerful investment vehicles available. When you reach retirement age, your retirement plan assets may be a significant portion of your overall savings. Therefore, it is important to do everything you can to get the most out of one of the best investment opportunities you have. Listed below is information to consider when conducting a review of your retirement plans.

Generally, when you begin to withdraw funds from your retirement plans, you will be subject to tax on the distributions. If you made after-tax contributions to your plan, a portion of each distribution will be tax-free. Also, special rules apply to Roth IRAs that make them particularly beneficial. If distributions begin prematurely (generally before age 59 1/2), you may be hit with a 10% penalty tax, but exceptions are available.

When you reach age 70 1/2 (or in some cases, retire), you must start withdrawing a minimum amount from your traditional IRAs and qualified plans each year. Severe penalties can result if required minimum distributions are not made on a timely basis. However, distributions from Roth IRAs are not required during your lifetime.

At the time of your death, the beneficiary designation in effect will determine not only who gets the retirement plan assets, but also how quickly your account must be paid out to your beneficiary and, therefore, how quickly the benefits of tax deferral are lost. Beneficiary designation adjustments may be necessary as family and beneficiary conditions change (e.g., divorce).

Your retirement plan savings may be critical for you and your dependents' future well-being. With proper planning, you can maximize tax-deferred earnings, avoid penalty taxes, choose a desired beneficiary, and minimize the amount your heirs are required to withdraw (and pay taxes on) after your death.

## Social Security Update

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The annual inflation adjustments have been announced for the various Social Security amounts and thresholds, so we thought it would be a good time to update you for 2014.

For Social Security beneficiaries under the full retirement age, the annual exempt amount increases to \$15,480 in 2014, up from \$15,120 in 2013. These beneficiaries will be subject to a \$1 reduction in benefits for each \$2 they earn in excess of \$15,480 in 2014. However, in the year beneficiaries reach their full retirement age, earnings above a different annual exempt amount apply. Earnings greater than \$41,400 in 2014 (up from \$40,080 in 2013) are subject to a \$1 reduction in benefits for each \$3 earned over this exempt amount. Social Security benefits are not reduced by earned income beginning with the month the beneficiary reaches full benefit retirement age. But remember, Social Security benefits received may be subject to federal income tax.

The Social Security Administration estimates the average retired worker will receive \$1,294 monthly in 2014. The average monthly benefit for an aged couple where both are receiving monthly benefits is \$2,111. These amounts reflect a 1.5% cost of living adjustment (COLA).

The maximum 2014 Social Security benefit for a worker retiring at full retirement age is \$2,642 per month, up from \$2,533 in 2013.

## Taxpayer Penalized for Wasting Court's Time

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A self-employed hearing aid specialist ("petitioner") claimed he had no taxable income and made no estimated tax payments on his 2006 and 2007 tax returns. Through third-party information returns and a bank account analysis, the IRS determined he had unreported business receipts of \$209,331 for 2006 and \$279,600 for 2007. After finding him liable for the deficiencies, the Tax Court judge said, "Without exception, petitioner has raised only frivolous and groundless arguments." In addition to the tax deficiency, penalties of \$30,000 were assessed for wasting the time and resources of the court.



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Cathleen M. Petersen, E.A.  
Cathleen@cathleenpetersen.com  
Phone: 408-741-1412 • Fax: 408-741-1158  
For more information visit:  
[www.cathleenpetersen.com](http://www.cathleenpetersen.com)



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