CHESAPEAKE ACCOUNTING CO. INC.
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Tax Preparation
Investment Advisor
513-882-3530
CINCINNATI • HARRISON, OHIO
www.ChessieAccounting.com

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This October newsletter covers rental property and the new Net Operating Loss (NOL) tax law change. Every monthly newsletter is available on my website.

Do you have children that have part-time jobs? Now is a great time for them to start saving. As an investment advisor, I can teach them just how much more money they can have at retirement, by investing as little as $25/mo.

Drive Time Increases Odds of Deducting Rental Property Losses

Your rental properties provide tax shelter when you can deduct your losses against your other income. One step to deducting the losses is to pass the tax code’s 750-hour test. And one step to finding the hours you need to pass the time test may be your drive times.

Trzeciak Case

Mariam Trzeciak owned, managed, and rented 14 single-family homes in and near Columbus, Ohio. She and her husband, Marc, on their joint tax returns claimed rental property losses of $126,376 and $151,884 in the two years that were subject to this IRS audit.

The IRS revenue agent assigned to examine the Trzeciaks’ returns disallowed the losses as passive losses, claiming that Mariam did not qualify as a real estate professional because she could not count her drive time from her home near Dayton to Columbus, where the properties were.

It took Mariam’s CPA, who prepared her returns and assisted with the audit, and then her lawyers almost three years to surface the home-office deduction as the savior. Once it surfaced, the IRS allowed the drive time, and that allowed Mariam to deduct her rental property losses of $126,376 for year 1 and $151,884 for year 2.

Leyh Case

The *Leyh* case involved Richard Leyh and Ellen O’Neill. Ellen owned 12 rental properties in Austin, Texas, about 26 to 30 miles from her home at a ranch in Dipping Springs, Texas.

Ellen and Richard deducted a $69,531 loss from their rental operations. The IRS said no because Ellen, without inclusion of her drive time, failed the 750-hour test to establish herself as a real estate professional.

The sole question that the court had to address was whether Ellen could include her drive time from her home to the rentals as rental property time. Interestingly, she failed to include her travel time in her well-kept log of time and had to reconstruct that travel time for the court.

The court ruled that her reconstruction of the travel time to and from the properties was adequate and ruled that she and Richard could deduct her $69,531 in rental losses on their joint tax return.

What You Should Do

Take the steps necessary to make your rental property drive time count as material participation time. The first step is to keep an accurate log of the time that you spend on your rentals (yes, we know this is a pain).

Audit-Proof Your Time Spent on Rental Properties

If you claim status as a tax law–defined real estate professional who can deduct his or her rental property losses, your time record for the year must prove that you spent

1. more than one-half of your personal service time in real property trades or businesses in which you materially participate, and
2. more than 750 hours of your personal and investor services time in real property trades or businesses in which you materially participate.

If you are married, either you or your spouse must individually qualify as a real estate professional. If one spouse qualifies, both spouses qualify.

Achieving real estate professional status is the first of two steps. You face one additional hurdle. To deduct tax losses on a rental, you also must prove that you materially participated in the rental activity. If you are married, you and your spouse may count your joint efforts toward passing the material participation tests. Most of the tests for material participation are based on hours worked.

What Does This Mean to You?

In simple terms: keep a time log. In an audit of your real estate activity, the IRS tells its examiner:

Request and closely examine the taxpayer's documentation regarding time. The taxpayer is required under Reg. Section 1.469-5T(f)(4) to provide proof of services performed and [of] the hours attributable to those services.

If you don't have what the IRS wants, your odds of winning your rental property tax loss deductions are slim, if that. And don't think you can create this log after the fact. Most everyone who spends the considerable time it takes to jump through the hoops to create an after-the-fact log of hours using the IRS spreadsheets loses the deductions.

Changes to Net Operating Losses After Tax Reform

Tax reform made many good changes in the tax law for the small-business owner. But the changes to the net operating loss (NOL) deduction rules are not in the good-changes category.

Now, if you have a bad year in your business, the new NOL rules are designed to stop you from using your business loss to find some immediate cash. The new (let's call them bad-for-you) rules certainly differ from the prior beneficial rules.

Old NOL Rules

You have an NOL when your business deductions exceed your business income in a taxable year. Before tax reform, you could carry back the NOL to prior tax years and get refunds of taxes paid in those prior years.

Alternatively, you could have elected to waive the NOL carryback and instead carry forward the NOL to offset some or all of your taxable income in future tax years.

New NOL Rules

Tax reform made two key changes to the NOL rules:

1. You can no longer carry back the NOL (except for certain qualified farming losses).
2. Your NOL carryforward can offset only up to 80 percent of your taxable income in a tax year.

The changes put more money in the IRS's pocket by

- eliminating your ability to get an immediate tax benefit from your NOL carryback, and
- delaying your ability to get tax benefits from future NOL carry forwards.

We are bringing the NOL rules to your attention in case you need to do some planning with us. We likely have some strategies that can help you realize some immediate benefits from your business loss.

Sincerely,

Robyn Urig EA

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