TAX NEWS

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SPRING 2022

Dear Client:

So far this year, both Congress and the IRS have been quiet with no new legislation or significant tax changes to report. There are some bills going through Congress at this time proposing changes to retirement plans and changes to tax filings, but there are still several hurdles to cross before they are signed into law. So, at this time we will revisit some provisions that were an issue for clients during the most recent tax season. We will look at ways to reduce your tax liability for 2022 - planning should start now! In some instances, if you are taking full advantage of tax deferred options at work, and no other tax planning strategies are available then the plan is to be sure you are having enough taxes withheld from payroll or are making adequate estimated taxes throughout the year.

One way to automate your estimated tax payments is to set up an account through the Electronic Federal Tax Payment System (EFTPS). Unlike DirectPay through the IRS website, this is a process that requires setting up your account then waiting for the IRS to send confirmation along with your PIN in order to access the system. But it does allow for more flexibility in setting up payment options and scheduling automatic payments for up to six months. Both systems are available to individual taxpayers (business taxpayers cannot use DirectPay) and there is no fee to use either system.

We are available year-round to assist with your tax issues and questions. If there is a life change that will affect your tax filing, it is better to inform us sooner rather than later so that any adjustments to your tax planning can be initiated.

For our business clients, we offer a full range of back-office services to assist with your compliance requirements. Contact us regarding services such as payroll processing, accounting services including real time posting and reconciliations, QuickBooks setup and training, financial statement preparations, business planning, and succession planning whether for sale of the business or retirement.

TRANSFERRING YOUR HOME TO YOUR ADULT CHILD

With today's home prices and the crazy real estate market, it is likely difficult for your children to buy a home. And you may be ready to move on from your existing home.

If this is true, consider the three options below.

OPTION 1: Make an Outright Gift

Say you are feeling so generous that you might just simply give your home to your adult child. What a deal for the kid!

Tax-wise, if you make the gift this year, it will reduce your $12.06 million unified federal gift and estate tax exemption. To calculate the impact, reduce the fair market value of the home you would be giving away by the annual federal gift tax exclusion, which is $16,000 for 2022. The remainder is the amount that would reduce your unified federal exemption.

If you are married, your spouse has a separate $12.06 million unified federal exemption. If you and your spouse make a joint gift of the home, each of your unified federal exemptions will be reduced. To calculate the impact, take half of the fair market value of the home minus the $16,000 annual exclusion. The remainder is the amount by which you would reduce your unified federal exemption. Ditto for your spouse's separate exemption.

If your child is married and you give the home to your child and his or her spouse, you can claim a separate $16,000 annual exclusion for your child's spouse.

If you expect the home to continue to appreciate (seemingly a pretty good bet), getting it out of your estate by giving it away is a good estate-tax strategy.

OPTION 2: Arrange a Bargain Sale

Say you are feeling generous, but not so generous that you want to simply give away your home.

Consider selling the home to your child for less than fair market value. For federal gift tax purposes, this is treated as a gift of the difference between the home's fair market value and the bargain sale price. Tax-wise, this can work out okay.

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TRANSFERRING YOUR HOME TO YOUR ADULT CHILD ... CONTINUED FROM PAGE 1

EXAMPLE: You are unmarried and decide to sell your residence, with a fair market value of $750,000, to your unmarried daughter for $250,000. Taxwise, you have made a gift of $484,000 ($750,000 less $250,000 less the annual gift tax exclusion amount of $16,000).

This reduces your $12.06 million unified gift and estate tax exemption by $484,000 so in all likelihood you will not have any federal gift tax due. However, note that Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, will need to be filed to report the reduction in your lifetime exemption amount.

What are your tax consequences of a bargain sale? To calculate your loss or gain, subtract your basis in the home (original cost plus any improvements or upgrades) from the sale price of $250,000. If you have a gain, it is eligible for the $250,000 capital gain tax exclusion as long as you meet the requirements. Any loss is non-deductible on a primary residence.

WARNING. Do not make a bargain sale or an outright gift of the home if you intend to continue living there. In these scenarios, expect the IRS to argue that the home's full date-of-death fair market value must be included in your estate for federal estate tax purposes, even if you were paying fair market rent to your child.

OPTION 3: Arrange Full-Price Sale with Seller Financing from You

Consider selling the home to your child for its current fair market value with you taking back a note for a big part of the purchase price. You can charge the lowest interest rate the IRS allows without any adverse tax consequences. That's called the "applicable federal rate" (AFR).

AFRs change monthly in response to bond market conditions and are generally well below commercial rates. In April 2022, the long-term AFR, for loans of more than nine years, is only 2.25 percent (assuming annual compounding). The mid-term AFR, for loans of more than three years but not more than nine years, is only 1.87 percent (assuming annual compounding).

As this was written, the going rate nationally for a 30-year fixed-rate commercial mortgage was around 6.1 percent, while the rate for a 15-year loan was around 5.6 percent.

So, for a loan made in April 2022, you could take back a 30-year note that charges the long-term AFR of only 2.25 percent. Alternatively, you could take back a nine-year note that charges the mid-term AFR of only 1.87 percent. Either arrangement would be a money-saving deal for your child.

KEY POINT – go through the legal process of securing the note owed to you for the home. Otherwise, your daughter will not be able to treat the interest paid as deductible qualified residence interest (if they are eligible to itemize their deductions). Related party transactions are subject to different rules and scrutiny, it is best to have the paperwork in place to support the tax deduction for the daughter.

Do not hesitate to contact our office if you would like to discuss transferring your home to your adult child.

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Is Your Freelance Activity a Business or a Hobby?

Do you have income from a freelance activity that you think of as a business? From this activity, are you claiming tax losses on the Schedule C of your Form 1040? Will the IRS consider your freelance work a business and allow your loss deductions?

The IRS likes to claim that money-losing freelance activities are hobbies rather than businesses. The federal income tax rules for hobbies have been anti-taxpayer for years, and now an unfavorable change enacted in the Tax Cuts and Jobs Act (TCJA) made things even worse for 2018-2025.

If you can show a profit motive, not necessarily a tax profit, for your now-money-losing freelance activity, you can classify that activity as a business for tax purposes and deduct the losses.

Factors that can prove (or disprove) such intent include:

- **Conducting the activity in a business-like manner** by keeping good records and searching for profit-making strategies.
- **Having expertise in the activity** or hiring advisors who do.
- **Spending enough time to justify the notion** that the activity is a business and not just a hobby.
- **Expectation of asset appreciation:** this is why the IRS will almost never claim that owning rental real estate is a hobby, even when tax losses are incurred year after year.
- **Success in other ventures**, which indicates that you have business acumen.
- **The history and magnitude of income and losses from the activity:** occasional large profits hold more weight than more frequent small profits, and losses caused by unusual events or just plain bad luck are more justifiable than ongoing losses that only a hobbyist would be willing to accept.
- **Your financial status:** significant income from other sources may indicate that you can afford to absorb ongoing losses (which may indicate a hobby), while the self-employed are usually trying to make a buck (which indicates a business).
- **Elements of personal pleasure:** breeding race horses is lots more fun than draining septic tanks, so the IRS is far more likely to claim the former is a hobby if losses start showing up on your tax returns.

It is important to document your business activities, keep books and records, and follow the regulations in your area to support your position. Join professional organizations, participate in networking or marketing events, and engage in activities that further your business cause.

Give us a call to talk about your planned or ongoing business activities and the steps needed to maintain your business as a ongoing concern to be considered a business and not a hobby.

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DEDUCTING MORTGAGE INTEREST WHEN YOUR NAME IS NOT ON THE DEED

Tax law has an exception for unconventional homeowners. You can deduct the mortgage interest payments even when the deed to the house and the mortgage are in someone else's name.

EXAMPLE: Sue could not personally qualify for a home loan. Her parents stepped in to help. They bought the house, from an unrelated seller, and signed the mortgage.

Sue lives in the home and pays all the expenses of the property, including the property taxes and the mortgage. Using a little-known tax rule, Sue deducts the mortgage interest payments she makes on her individual income tax return, Schedule A, Itemized Deductions.

What is even more interesting is that Sue found out about this little-known rule after she had been making payments for a few years. Once she learned the rule, Sue amended three years of tax returns, claiming about $18,000 per year in deductions, and received a sizable tax refund.

If you are in a similar situation, you could be eligible for this tax deduction as well. You simply need to prove that you are the "equitable owner" of the property, as you can deduct the interest as long as you are either the legal or equitable owner of the property that secures the mortgage.

"Legal" title and "equitable" title are two different things. You just need one or the other to qualify for the interest deduction.

LEGAL TITLE. This simply means legal ownership according to the real estate laws of your state. In general, legal title requires a deed of ownership that is properly recorded according to the laws of your state.

EQUITABLE TITLE. Under this doctrine, you prove that even though you do not have legal title, you bear the benefits and burdens of the property and are thus the true owner under the law for certain purposes.

When a court considers an equitable ownership claim, the judge looks at all the facts and circumstances of the situation. The factors the courts consider are:

- right to possess the property and enjoy its use, rents, or profits;
- duty to maintain the property;
- responsibility for insuring the property;
- risk of loss on the property;
- obligation to pay the property's taxes, assessments, or charges;
- right to improve the property without the legal owner's consent; and
- right to get legal title at any time by paying the balance of the purchase price.

You do not have to prove every single element in the list, but you want to show as many as possible. The more elements you have on your side, the stronger your case will be.

If your home is yours, in every sense except legal title, contact the office to see if you would qualify for the itemized deductions offered by home ownership. ■

IRAS FOR KIDS

We have talked about the benefits of employing your child in your business whether you are sole proprietor filing a Schedule C, Profit or Loss From Business, or a corporate shareholder employee filing a corporate return.

Working at a tender age is an American tradition. What is not so traditional is the notion of kids contributing to their own IRA, especially a Roth IRA. But it should be a tradition, because it is a really good idea.

Here is what you need to know about Roth IRAs for your child.

ROTH IRA CONTRIBUTION BASICS

The only federal-income-tax-law requirement for a child to make an annual Roth IRA contribution is to have enough earned income during the year to cover the contribution. Age is completely irrelevant.

So, if a child earns some cash from your business, a summer job or part-time work after school, he or she is entitled to make a Roth contribution for that year.

For the 2022 tax year, your working child can contribute the lesser of:

- his or her earned income for the year, or
- $6,000.

While the same $6,000 contribution limit applies equally to Roth IRAs and traditional IRAs, the Roth option is usually better for kids.

The benefit for you as the business owner is that the payroll would be a business expense transferring some of your business income from your higher tax bracket to your child who may be in a zero or 10% bracket. Your business must file the appropriate payroll tax returns (generally the quarterly Form 941 and the year-end Form W2) and the child must have a bona fide business role for their compensation.

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IRAS FOR KIDS

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Modest Contributions to Child's Roth IRA Can Amount to Significant Retirement Benefits

By making Roth contributions for a few years during the teenage years your child can potentially accumulate quite a bit of money by retirement age. But realistically, most will not be willing to contribute the $6,000 annual maximum even when they have enough earnings to do so.

Say the child contributes $2,500 at the end of each of the four years. Assuming a 5 percent return, the Roth account would be worth about $82,000 in 45 years. Assuming an 8 percent return, the account value jumps to an increased benefit $259,000 (assumptions for illustration purposes only).

You get the idea. With relatively modest annual contributions for just a few years, Roth IRAs can be worth significant amounts by the time your "kid" approaches retirement age.

The benefit of the Roth IRA compared to the traditional IRA is that the child generally has a low tax rate, the Roth continues to grow tax deferred and the distributions are tax free at retirement. The traditional IRA, if the child has taxable income, may get a small tax benefit now, the fund grows tax deferred and the distributions are taxable at retirement. Working with a financial advisor and running the numbers will show the tax benefits of starting the Roth IRA when the child gets their first job and continuing to have the tax benefits throughout their lifetime.

Our office can provide you with the resources and referrals needed to establish a Roth IRA or consider other tax deferred or investment opportunities.

Roxie T.

DO YOU QUALIFY FOR A HEALTH SAVINGS ACCOUNT?

Personal finance experts estimate that an average retired couple age 65 or older will need at least $300,000 to cover health care expenses in retirement. While Medicare and supplemental insurance provides some coverage, there are costs that you may incur or specialists that you may want to use that are not covered by your insurance. Some procedures considered "experimental" by Medicare will not be covered and you will have to pay for those treatments out-of-pocket.

The time to save for these expenses is before you reach age 65. And the best way to do it may be to open a Health Savings Account (HSA). After several years, you could have a significant HSA balance that will help pave your way to a comfortable retirement.

Not everyone can have an HSA. But you can if you are self-employed or your employer does not provide health benefits. Some employers offer, as an employee fringe benefit, either HSAs alone or HSAs combined with high-deductible health plans.

An HSA is much like an IRA for health care. It must be paired with a high-deductible health plan with a minimum annual deductible of $1,400 for self-only coverage ($2,800 for family coverage). The maximum annual deductible must be no more than $7,050 for self-only coverage ($14,100 for family coverage). The coverage amounts are adjusted annually for inflation.

An HSA can provide you with three tax benefits:

1. You or your employer can deduct the contributions, up to the annual limits.
2. The money in the account grows tax-free (and you can invest it in many ways).
3. Distributions are tax-free if used for medical expenses.

No other tax-advantaged account gives you all three of these benefits for health-related costs.

What if I leave my job or switch health plans? The great thing about having an HSA is that it is completely yours. So, when you get a new job or change health plans, your HSA and all the money in it come with you. You can roll the account into your new employer's HSA or leave it alone, but those funds are yours to use for qualified expenses either way.

Remember, you have to be enrolled in an HSA-qualified health plan to put money into an HSA. Keep that in mind when you are changing jobs or health plans. When you switch from an HDHP to a traditional health plan that is not qualified for an HSA, you can no longer put money into your existing HSA. You can, however, continue to use the funds that are in your HSA for qualified medical expenses!

You have complete flexibility in how to use the account. You may take distributions from your HSA at any time. But unlike with a traditional IRA or 401(k), you do not have to take to take annual required minimum distributions from the account when you turn age 72.

Indeed, you need never take any distributions at all from your HSA. If you name your spouse the designated beneficiary of your HSA, the tax code treats it as your spouse's HSA when you die (no taxes are due).

If you maximize your contributions and take few distributions over many years, the HSA will grow to a tidy sum.

Contact our office to discuss your eligibility for an HSA and how it can benefit your tax situation.