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Summaries of the 7th Annual IRS SJSU Small Business Tax Institute Rental of Residences in the Modern World

By: *Chen Chen, MST Student*

At the 7th Annual IRS/SJSU Small Business Tax Institute on May 30, 2019, Claudia Hill, EA, MBA, President of TaxMam, Inc., and Annette Nellen, CPA, CGMA, Esq, Professor at San Jose State University, presented on the topic rental of residences and the changes after the Tax Cuts and Jobs Act (TCJA).

During the presentation, Ms. Hill highlighted three main rental issues in the modern world for tax purposes- rental to family members at less than fair market value, variations on vacation rentals, and qualified business income deduction on real estate rental activities.

Under Section 162(a)(3), a deduction is allowed for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including... rental or other payments required to be made as a condition to the continued use or possession”. However, when the lessor and the lessee are related, the terms of the lease must be structured carefully to avoid the implication that the arrangement is just a way to transfer funds and avoid taxes. When the rent payments are determined to be unreasonable, a portion of the lessee’s rent deduction, in excess of the rental income of the lessor, is disallowed. The IRS determines if the taxpayers do not earn a profit in at least three of the prior five years, the business might be considered a hobby.¹ Therefore, running a rental business with large losses year after year might trigger an IRS audit. In addition, when there is disposition of the passive activity to a related party, any suspended loss incurred in the transaction remains with the original seller.²

In general, the tax treatment of a vacation home depends on the mix of personal and rental use. If the taxpayer rents out the residence for less than 15 days during the taxable year, any income from the rental is excluded from gross income and any deductions from the rental are disallowed.³ However, interest expense and property tax may be deductible on Form 1040, Schedule A. If the home is rented out for 15 days or more, the rental income will be reported on Schedule E, and the prorated rental expenses can be deducted, but may be limited to the gross rental income limitation.⁴ When the home is considered a residence of the taxpayer and it is used for personal purposes for more than the greater of 14 days or 10 percent of the total numbers of days the home has been rented out at fair rental value, the rental expense cannot exceed the rental income,⁵ but the additional expenses can be carried forward and a personal portion of mortgage interest, and property taxes may still be claimed on Schedule A.

¹ Section 183.

² Section 469(g)(1)(B).

³ Section 280A(g).

⁴ Section 280A(b) and (c)(5).

⁵ Section 280(e).

Conversely, if the home is not also used as a residence, the expenses in excess of rental income can be deducted. However, the loss will be limited by the passive-activity loss limitation rules of Section 469.

For clarification of the operation of the limitations of Section 280A(b) and (c)(5) after the TCJA, the IRS issued Program Manager Technical Advice 2019-01, to advise about the interplay between the \$10,000 limit on the state and local tax (SALT) deduction,⁶ and the amounts that are permissible as a deduction for expenses in connection with business use of a home under Section 280A. The PMTA concludes that if a taxpayer exceeds the SALT limitation, or opts to take the standard deduction, then none of the taxpayer's SALT relating to the taxpayer's business use of home are included as expenses under Section 280A(b).⁷ On the other hand, if the amount of taxpayer's SALT is less than \$10,000 limitation and they choose to itemize deductions, then the taxpayer can include as an expense under Section 280A(b) the business portion of the SALT up to the difference between the \$10,000 limitation and the amount of the SALT the taxpayer actually deducted under Section 164.

Nowadays, renting homes or spare rooms on third-party platforms, like Airbnb or VRBO, is a quick way to earn extra cash and offset living expenses. However, it is also a hot-button issue that the IRS has been paying attention to and has recently launched a sharing economy tax center website given how prevalent the sharing economy has become. Taxpayers who offer their properties for rent through third-party platforms, are subject to the income tax rules for residential rental property and may receive Form 1099-K if they receive gross payments via the platform company website that exceed \$20,000 and more than 200 transactions. However, regardless of whether the Form 1099-K is received, the taxpayer is obligated to report the taxable income on his income tax return. Short-term rental activities can be classified into three categories: Schedule E rentals under Section 469⁸ Schedule C rentals such as for a bed-and-breakfast operation, and non-taxable rentals of less than 15 days.

A rental activity generally falls into the category of Schedule E rental when a host does not provide substantial services for the convenience of guests; otherwise, it can be classified as a Schedule C business activity and subject to self-employment taxes if substantial personal services are provided to guests. The substantial services include, but are not limited to, cleaning of the rental portion of the property, concierge exercises, guest tours and outings, meals and entertainment, transportation and other hotel-like services. When the property was used primarily as a personal residence and rented out less than 15 days at fair rental value, Section 280A(g) applies. Furthermore, as Professor Nellen reminded attendees, taxpayers with positive

⁶ Section 164.

⁷ Section 280A(b).

⁸ Section 469 (c): the rental activity is treated as passive activity, in which the taxpayer does not materially participated in the conduct of trade or business. If the rental is a trade or business such as because the average rental period is seven days or less and the owner materially participates, the activity is still reported on Schedule E unless significant personal services are offered such that the income is subject to self-employment taxes under Section 1402, in which case it is reported on Schedule C.

taxable income from the sharing economy activities may also be subject to state and local taxes, such as transient occupancy taxes, business license tax and personal property taxes. The Tax Cuts and Jobs Act gave us the most significant and dramatic changes to the Internal Revenue Code. One of the biggest changes was the addition of Section 199A, which allows certain business owners to claim up to 20 percent deduction on the profits of their business. However, determining whether a rental activity is an investment or business activity is crucial, because the Section 199A deduction is not available if the rental activity is not a qualified trade or business.

So, what if the taxpayers are regularly renting out their homes for profit motive,⁹ but not actively participating in the activities?¹⁰ Will it still be a qualified business? These questions have not been adequately answered by the Congress in the Tax Code. But, as Professor Nellen mentioned, throughout the past years, several court opinions have shown to be in favor of treating the rental activities as a business. Even so, in an effort to help provide clarity and guidance on this issue, the IRS released Notice 2019-07. It contains a proposed Revenue Procedure providing a safe harbor for treating a rental real estate as a business for purpose of the Section 199A deduction. To qualify for the safe harbor, a total of at least 250 hours of documented rental services must be provided by the taxpayer or others during the year. Taxpayers who do not meet the safe harbor requirement may still qualify as a business if they can prove the rental meets the definition of a trade or business under case law, and the judgement will be made on a case-by-case basis on a good faith effort.

Furthermore, another concern that has surfaced is about losses. Even if a rental produces a loss, the taxpayer must still determine if it is a trade or business because if it is, the loss reduces qualified business income from other businesses in computing the Section 199A deduction. If there are no other businesses, the loss carries forward to reduce future income from the rental business. There are lot of uncertainties that still need to be resolved because of the changes in the tax law.

While the tax laws are still evolving, as tax professionals, we must exercise due diligence to make sure clients are in compliance with the current tax rules as well as consider planning to alleviate any undue tax burden.

⁹ *Groetzinger*, 480 U.S. 23, 35 (1987) has pointed that “to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer’s primary purpose for engaging the activity must be for profit”.

¹⁰ Section 469 (c)(7)(B): in order to treat the rental activities to be non-passive activity, the taxpayer must materially participate in the activity which is equivalent to more than 750 hours of the services during the taxable year.

Helping Employers Serve Their Multicultural Workforce

By: Liwei Bi, MST Student

At the 7th Annual IRS-SJSU Small Business Tax Institute held on May 30, 2019 at the Biltmore Hotel in Santa Clara, Mr. Carlos Lopez, EA of Lopez Tax Service, and Mr. Carlos Zepeda, of the IRS LB&I Withholding & International Individual Compliance Office, addressed the importance and necessity of identifying the tax status of workers. It is not uncommon to find nonresident alien employees working alongside U.S. citizens. From an employer perspective, correct determination of an employee's residency status is critical in determining the federal and state withholding taxes, Social Security tax, as well as the employer's federal unemployment tax (FUTA).

The first step in determining the withholding and reporting requirements for an employer is to determine whether the employee is a U.S. citizen, resident alien or a nonresident alien. If the employee is a U.S. citizen or a resident alien with a green card, the employer must comply with the usual withholding rules. In addition, a nonresident alien that meets the "substantial presence test" is generally defined as having a physical presence in the U.S. for more than 31 days in the current taxable year and more than 183 days during the previous three years. To calculate the number of substantial presence days for the current year, count all the days; for the prior year, count one-third of the days; and second prior year, count one-sixth of the days.

If the test is met, then even a nonresident alien is subject to the usual withholding rules with certain exceptions for any foreign government related individual, teachers or trainees under the J, U visas, students under the F, J, M or Q visas, and professional athletes in the U.S. competing in a charitable event. Form 1042-S is for non-residents who conduct some form of business within the United States. The form is sent to the non-resident by the bank or corporation that handles the transaction.

Once an employee is determined to be a resident alien, there may be one other exemption. If the employee is a tax resident from a country that has a treaty with the U.S. to exempt them from withholding. For income tax purposes, a U.S. resident alien is taxed on their worldwide income. A nonresident alien will be taxed on all income earned in the U.S., and any other income effectively connected with a trade or business or passive income that is considered fixed, determinable annual, periodic (FDAP) income from sources within the U.S.

For Social Security tax purposes, the employer must pay the tax regardless of citizenship or residency of the employees except if they have a F, J, N, or Q visa including for all income related to work performed outside of the U.S. for resident aliens but not for nonresident aliens.

Finally, for the federal unemployment tax (FUTA), the employer must pay the tax for resident and nonresident aliens except for wages paid to students, railroad workers and agricultural workers. Mr. Zepeda noted that helpful IRS publications for these rules include Circular A, Circular E, and Publications 54, 514, 519, and 901.

TCJA Cautions and Reminders

By: *Surbhi Doshi, MST Student*

The 7th Annual IRS/SJSU Small Business Tax Institute was held on May 30th, 2019 at the Biltmore Hotel in Santa Clara. A panel of seven experts spoke about the challenges faced and important things to remember after the Tax Cuts and Jobs Acts of 2017 (TCJA). The panel consisted of Claudia Hill, EA, MBA, President of TaxMam Inc.; Carlos Zepeda, Withholding and International Individual Compliance Office IRS LB&I; Ericka Shuper, CPA, Senior Manager in Tax at Squar Milner; Joel Busch, CPA, Esq. Professor at San Jose State University; Vicki Mulak, EA, CFP; Annette Nellen, CPA, Esq., Director and Professor of the MST Program, San Jose State University; and Chris Grindy, VP of Grindy Tax Services, Inc. The panel spoke about the queries experienced during the first filing season after the TCJA, a few international tax changes, the disallowance of certain expenditures and NOLs and the extent of California's conformity to federal changes.

Ms. Claudia Hill began the presentation with issues faced and the ambiguities about the new laws and regulations passed by the TCJA and their applicability during this filing season. The IRS issued guidance throughout the filing season and the software providers integrated it into the software. One of the major concerns was that, while the tax returns for 2018 were filed to the best interpretation of the guidance available then, will the interpretation and hence the treatment of certain items change when more IRS guidance is issued? Will this trigger any of the automatic accuracy related penalties and the preparer penalties by the IRS? This is followed by the concerns among the clients about the differences of treatment of certain items in 2018 versus the 2019 tax return.

Tax laws affect the behavior of people and what trends it sets in the society. At a conference in USC where she recently spoke, she asked the audience about the effects of the change of law regarding mortgage interest, Schedule A property taxes and the state and local tax (SALT) limitation. One of the consequences is that there may be less ownership of principal residences and more of corporate owned homes because of REIT benefits. The limit on home acquisition debt of \$750,000 and disallowance on property tax deduction have resulted in a change in people's attitude towards home ownership in Silicon Valley where the property prices are one of the highest in the country. It affects the attitude of the newer generation who might want to spend more now rather than saving for buying a house due to the reduced tax incentives. Tax practitioners must continuously watch out for new regulations and other guidance coming out to ensure that the client returns are filed to the best interpretation of the law at the time.

Mr. Carlos Zepeda briefly covered some international changes introduced by the TCJA. He believed that the tax reform has brought learning opportunities to tax practitioners as well as the IRS. The IRS is facing challenges in issuing the publications and other guidance relating to the changes. The major areas of change in the international area impacting taxpayers in control of foreign corporations include Section 951A – Global Intangible Low Taxed Income (GILTI). U.S. shareholders now have to include income from such Controlled Foreign Corporations (CFCs) on an annual basis as opposed to reporting on a receipt basis. To reduce the harsh effects of GILTI,

TCJA introduced Section 250, available to corporations, a 50 percent reduction of the income that is reported under GILTI. Section 962 allows individuals to make an election to be treated as a corporation and claim the Section 250 deduction on the GILTI inclusion amount. If not for this deduction, individuals could be taxed at 37 percent on the GILTI inclusion in their income. Section 951 also changed the definition of the U.S. shareholder as any U.S. person who owns 10 percent or more of the total value (earlier it was voting power) of shares of all classes of stock of a foreign corporation. The TCJA made changes to the sourcing rules of produced goods under Section 863(b) where anything produced in the U.S. will be treated as U.S. sales, not foreign sales. Tax reform changed Section 904 and added a GILTI tax basket wherein no carryback or carryforward is allowed for the GILTI tax credit that cannot be used in the tax year in question.

Ms. Ericka Shuper spoke about the changes brought in by TCJA regarding bonus depreciation for qualified improvement property. The Congress intended to make qualified improvement property have a recovery period of 15 years and thus eligible for bonus depreciation. But the Internal Revenue Code was not changed, and qualified improvement property has a recovery period of 39 years so it not eligible for bonus depreciation. In expectation of a technical correction on this from the Congress, many extensions for tax returns have been filed. She added that it is crucial to have proper communications with clients and document them properly to ensure that no important information is missed.

Professor Joel Busch spoke about the excess business loss limitation and the business interest deduction. The excess business loss rules apply to tax years beginning after December 31, 2017 and ending before January 1, 2026. The maximum loss allowed is \$250,000 (2018)/ \$255,000 for (2019) of the total net business losses to be deducted on the individual's tax return for the year. Taxpayers filing jointly have double the above referenced limits - \$500,000 for 2018 and \$510,000 for 2019. Any excess loss is treated as an NOL carryforward and is subject to the new 80 percent of modified taxable income limitation. Taxpayers are required to file Form 461 to report excess business loss. As California has static conformity, the excess business loss deduction limitation does not apply for the California income tax.

Professor Busch also spoke about the business interest deduction limitation of Section 163(j). This is an entity level business interest deduction limitation which applies to most business-related interest expenses in tax years beginning after December 31, 2017. The limitation does not apply to small businesses having average annual gross receipts over the prior three years of \$25 million or less. Taxpayers can deduct interest expense up to a maximum of 30 percent of adjusted taxable income plus any business interest income. Adjusted taxable income doesn't include the NOL deduction, business interest income and expenses and most cost recovery deductions like depreciation or amortization. Form 8990 is required to be filed if Section 163(j) applies and there is any current year business interest expense or any disallowed business interest expense carryforward. Lastly, due to the static conformity rules, California doesn't conform to this new business interest deduction limitation.

Ms. Vicki Mulak focused on California's non-conformity to the federal rules relating to home acquisition indebtedness where interest can be deducted on debts up to \$750,000 while the

threshold for California remains at \$1 million. She highlighted the complexities of Form 8829 for the federal home office deduction. The property taxes for home office deduction are impacted by the SALT limitation and interest on acquisition indebtedness which is limited on Schedule A both are required to be reported on Form 8829. Lastly, she spoke about the complexities of the new postcard-size Form 1040, which was actually designed to make it simpler, and clients' unfavorable reactions to it.

Professor Annette Nellen emphasized that the effective date of regulations that basically state something in the statute is really the effective date of the related statute. She briefly spoke about the *Argo Sales* case (*Argo Sales Company v. Comm'r.*, 105 TC 86 (1995)) where the court held that the "absence of regulations does not relieve us of the duty of interpreting our tax laws." The case involved a built-in gain issue and the S corporation did not include its Section 481(a) adjustment in the gain. The court agreed with the IRS that the taxpayer should include the Section 481(a) adjustment although the regulation stating that the built-in gain included the 481(a) adjustment were effective after the return was filed. The court said this interpretation was in the statute and thus its effective date controlled. Professor Nellen also reminded attendees that the small business definition of Section 448(c) was changed to include businesses having average annual gross receipts over the prior three years of \$25 million or less. This amount is adjusted for inflation to \$26 million for 2019. One thing to be cautious about is that the small business exception doesn't apply to a tax shelter as defined in Section 448 regardless of the entity's gross receipts level.

To conclude, Chris Grindy offered some tips about work-life balance and managing client expectations for tax practitioners. He highlighted the fact that it is important to not be afraid to say no to new clients when you don't have capacity to help them and to not compromise on the services to existing clients. In the end, he emphasized that tax practitioners should try to strike a healthy balance between both.

Summary

In a nutshell, all the speakers highlighted the importance of staying current with the TCJA changes and guidance and communicating with clients. Also, practitioners should discuss planning opportunities with clients and take the right steps to implement them.