

taxolutionsSM

Accounting For Vacation Homes Is No Picnic

“Looking to buy that cabin by the lake... If so, you may be asking, ‘What could I write off?’ ”

Looking to buy that cabin by the lake or a bungalow in Hawaii? If so, you may be asking, "What could I write off?" The answer varies depending on how much you use the home and how often you rent it out.

A Second Home

If you don't plan on renting out the vacation home, then it is considered a second home and you are generally allowed to deduct the same expenses as you do with your principal residence. So, you may deduct mortgage interest (subject to the \$1 million limit on acquisition indebtedness) and real estate taxes as itemized deductions on Schedule A of your Form 1040.

The one difference is in the case of points. Points paid on the purchase of your *primary* residence are immediately deductible; points paid on the purchase of a *vacation* home must be amortized over the term of the loan.

Some Use, Some Rental

If you use your vacation home yourself but also rent it out frequently, you may deduct some additional expenses. But you'll also have to report the rental income. If you personally use the home for more than 14 days or more than 10% of the days

rented, whichever is higher, you may deduct rental expenses to the extent of your rental income.

First, your mortgage interest and real estate taxes are allocated between the rental activity and Schedule A based on the days rented. If there is any remaining rental income after offsetting it with the allocated interest and taxes, the remainder is further



offset with the home's operating expenses (i.e., utilities, maintenance, and depreciation), which are deducted in a specific order. However, your rental expenses can never be greater than your rental income. Excess expenses are carried over to future years, but may end up never being used.

Generally, the vacation home must be rented out at its fair market value to qualify

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Great News For Small Businesses!

IRS Further Expands Cash Method Of Accounting

Small businesses have long struggled with IRS rules requiring use of the accrual method of accounting. This method not only requires complex recordkeeping, it also generally results in accelerated income and deferred deductions. But the IRS, apparently in a generous mood, gave small businesses a gift last December. The Service substantially expanded the cash method of accounting.

Under the cash method of accounting, income is typically recognized when payment is received; and expenses are deducted in the year in which they are paid. Conversely, the accrual method of accounting requires businesses to recognize income in

average gross receipts of \$1 million or less to use the cash method of accounting. However, these businesses were still required to account for inventories, including "material" supplies that were needed in order to provide certain services.

There is no clear definition as to what constitutes inventory versus supplies or what constitutes material supplies, which must be capitalized, versus incidental supplies, which can be immediately expensed.

Contractors and medical practices have been hit particularly hard as the IRS has often tried to force these types of businesses to the accrual method because of

"material" will be deducted either when used or when paid for... whichever is later.

Under the new rules, which may be applied to tax years ending on or after December 31, 2001, qualifying businesses can use the cash method of accounting if they meet one of four safe harbors:

- The principal business activity is not retailing, wholesaling, manufacturing, mining, publishing, or sound recording as determined by its SIC code.
- The principal activity is the provision of services, even if the business provides property incident to the services.
- The principal business activity is custom manufacturing.
- It has a separate and distinct trade or business that meets one of the above safe harbors, regardless of its primary business activity.

Note that this provision does not override the \$5 million threshold mentioned previously. Therefore, most C corporations with gross receipts over \$5 million will still need to use the accrual method of accounting.

Many Advantages

The IRS estimates that the new rules will simplify recordkeeping for as many as 500,000 small businesses. The change can also result in a deferral of income to the extent that the businesses' receivables historically exceed its payables and to the extent that the business had been capitalizing any of those incidental supplies.

Though these new rules are intended to simplify and can be very advantageous, changing your existing accrual basis business to the cash method is somewhat complex. It requires some calculations and filing an application for an automatic change in accounting method with the IRS.

If you think your business may be a candidate for switching to the cash method, please give us a call. We can assess the financial impact to your business and help you with the necessary paperwork.



the year it is earned and to deduct expenses in the year they are incurred.

Generally, all C corporations (except certain farms and personal service corporations) with average gross receipts of over \$5 million and all businesses that use inventory as a material, income-producing factor must use the more complex accrual method of accounting. Thus, the business has to keep meticulous records for accounts receivable, accounts payable, and inventory (where applicable).

The IRS provided limited relief in 2000 when it allowed all businesses with

the supplies consumed in their businesses. Carried to an extreme, this would make the doctor's office capitalize each bandage and the homebuilder capitalize every nail.

The Burden Is Lifted

The IRS has dramatically changed its position by allowing qualifying small businesses with average gross receipts of \$10 million or less to use the cash method of accounting.

In effect, many small businesses will no longer need to deal with inventories. Items considered "incidental" would be written off when purchased. Supplies that are

Like-Kind Exchanges — Still A Viable Tax Shelter

Are you holding onto appreciated property or real estate because you fear a large capital gains tax bill upon the property's disposal? Do you realize that the built-up equity in that property could be used to expand your business if it was available?

Don't let fear of a large tax bill paralyze you. You can circumvent this problem by entering into a like-kind exchange.

The IRS allows you to defer the gain on property as long as it is exchanged for replacement property of a like kind. What does like-kind mean? It's simply property of the same nature or character.

How Does It Work?

Most exchanges of real property qualify as like-kind exchanges, no matter what their use. For example, you could exchange farmland for an apartment building of equal or greater value without recognizing any gain at that time (providing neither property qualifies as your residence). Your basis in the new property is reduced by the amount of deferred gain, as shown in the example.

Creative Transactions

Referring to the example, what if the owner of the land didn't want George's land in exchange? If George had a buyer

for the farmland, he could hire someone to perform the sale and purchase. George would first transfer title of the farmland plus the cash to the facilitator. The facilitator would then: 1) sell the farmland, 2) purchase the new land, and 3) transfer title of the new land to George. Even though this is a three-party transaction, it would still qualify as a like-kind exchange if performed properly. However, there are special rules as to who qualifies as a facilitator and timing is critical. Don't attempt this type of exchange without consulting with us.

New Rules, New Benefits

Like-kind exchanges provide even more benefits now because of changes in the depreciation rules. Previously, depreciation on the entire amount of basis in the new property would start over.

Now, for exchanges occurring January 3, 2000 or later, the portion of the basis in the new property attributable to the remaining basis in the old property will continue to be depreciated as if the property was never disposed of. This will often result in faster depreciation than under the old rules.

Watch Your Step

Like-kind exchanges can also backfire. While they allow you to defer gain on an exchange, you must also defer any loss on the exchange. Therefore, it may be wise to sell certain properties where the fair market value is less than its undepreciated basis, such as in the case of an automobile trade-in. Things can also be tricky if debt is being transferred. You don't want to be surprised by gain.

The like-kind exchange is a powerful tax-planning tool... but it must be executed properly. The exchanges must occur within a certain proximity to each other, reporting requirements must be met, and the properties must qualify as like kind.

We can help you evaluate any like-kind exchange opportunities in your future.



EXAMPLE:

About 5 years ago, George purchased his first investment property, a parcel of land, for \$50,000. Today, the land is worth \$75,000. George wishes to dispose of it and buy a new parcel of land worth \$100,000. If George sells the land and then pays that \$75,000 plus an additional \$25,000 for the new land, here's what his tax situation would look like:

Sale and Purchase

Sale price of farmland	\$ 75,000
Less basis in land.	<50,000>
Gain on sale of farmland	25,000
Tax rate.	x 20%
Current year tax liability	\$ <u>5,000</u>

Basis of newly acquired land \$100,000

What if George trades his old land and \$25,000 in cash in exchange for the new parcel of land? That scenario would result in the following:

Like-Kind Exchange

Sale price of farmland	\$ 75,000
Less basis in land.	<50,000>
Gain on sale of farmland	25,000
Gain deferred.	<25,000>
Current year recognized gain	<u>0</u>

Cost of acquired property \$100,000
 Less: deferred gain <25,000>

Basis of newly acquired land \$ 75,000

Using a like-kind exchange would allow George to keep an additional \$5,000 in his pocket, which he can use to further expand his business and investment interests.

If George were to receive property of a like kind plus cash boot and/or other property in an exchange, he would have to recognize the gain, but only up to the value of the other property received. Any remaining gain would be considered as generated by the like-kind exchange.

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as a rental day. Otherwise, it qualifies as a personal day. This includes any days where you don't charge rent, such as when you let friends, relatives, clients, or employees stay at the residence. Personal days also include any days donated to a charity, perhaps for a charity auction (no charitable contribution deduction is allowed for the use of your vacation home).

Some taxpayers may only rent out their vacation homes occasionally, like when the PGA or NASCAR is in town. If you rent out your vacation home for fewer than 15 days, you don't have to report any rental income. Of course, you don't get to deduct any additional expenses either... but you'd still be able to deduct the interest and taxes on Schedule A.

Rental Property

If you don't use the vacation home for more than 14 days or more than 10% of the days rented, whichever is higher, then

the property is considered strictly a rental property. Generally, all of your expenses incurred due to the rental use of the property are deductible, even if they exceed the property's rental income. However, the mortgage interest allocable to personal use of the property is not deductible on Schedule A since the property is no longer considered a second home.

If you're thinking that rental losses will help lower your tax liability, think again. The use of rental losses is greatly restricted due to the passive activity loss rules. Under these rules, most higher income taxpayers are only able to use such losses on their return to offset net income from other passive investments or when the property is disposed of.

Company Use

If you're a small business owner and you want to let your company use the vacation home, the fair rental value of the property

should be charged to avoid any insinuations of extra benefits being provided to you or the company. If the use constitutes a sales or other award, the fair market value of the trip should be included in the employee's compensation.

Note that if this is the only rental use of the vacation home and it is for less than 15 days, you won't have to recognize the rental income. However, your company generally won't be able to deduct the rental expense because you are considered a related party.

Depending on how you are going to use your vacation home, the recordkeeping and reporting requirements can vary considerably. And treatment of gain on a later sale of the vacation home can be affected by rental use. We can help you determine how to handle your home away from home to accomplish your goals.

news and notes



Congress Extends Internet Tax Moratorium

At the end of last year, Congress extended the Internet tax moratorium, which was to have originally expired on October 21, 2001. The moratorium prevents states from assessing any new taxes on Internet access fees, and prevents multiple jurisdictions from assessing sales or use tax on the same transaction conducted over the Internet. The moratorium has been extended through November 1, 2003.

Elect To Get Lower Capital Gain Rate

The 18% capital gain tax rate went into effect on January 1, 2001. But the rate only applies to assets acquired on or after that date, which are held for at least 5 years. However, you can elect to treat any assets held on January 1, 2001 as having been sold on January 2, 2001 and reacquired on the same date. You will have to recognize any built-in gain as of that date, but the asset will now qualify for the 18% rate if held for 5 years.

While most taxpayers won't want to recognize gain now to save 2% down the road, it's definitely something to consider if you have net operating losses, capital losses, or charitable contribution carry forwards that you want to use up. We can help you make the necessary election on your tax return.