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Tax Newsletter

Five Prime Elections on 2023 Returns
Important tax decisions to make

In this presidential election year, you may also be casting some important "votes" on your 2023 federal income tax return. Here are five common elections that can make a significant tax difference.

1. Joint or separate returns: If you are married, one of your first tax return decisions is whether to file jointly or as marrieds filing separately. Generally, a couple fares better with a joint return, but that is not always the case. For example, one spouse might have a disproportionately large amount of deductible medical expenses. Due to the medical deduction floor of 7.5% of adjusted gross income (AGI), a couple collectively may benefit by filing separately. **Caveat:** This election has numerous other ramifications, so consider the overall impact.

2. Investment interest: The tax law allows you to deduct investment interest expenses up to the amount of net investment income for the year. Normally, "net investment income" for this purpose does not include capital gains. But you can elect to include capital gains for which you forgo the favorable tax rate. For 2023 returns, the maximum tax rate for long-term capital gains is 15% (20% for certain upper-income investors). Best of all, you can "cherry-pick" the gains you want to treat as net investment income.

3. Installment sales: If you sell real estate or business interests in installments over two or more years, the tax liability is spread over the time payments are actually received. In effect, you postpone the tax from the sale, as well as possibly reducing the overall tax amount if more of the gain qualifies for the 15% capital gains rate. Although this installment sale tax treatment is automatic, you can elect to pay the **entire tax** due in the year of the sale if it suits your purposes. This might be preferable on a 2023 return if it is otherwise a low tax year, or you expect the next few years to be high tax years.

4. Home office deductions: Typically, a self-employed individual running a business from home qualifies for home office deductions. As a result, you are entitled to deduct expenses directly attributable to the home office, plus a portion of the entire home's expenses based on the percentage of business use of the home. However, instead of keeping detailed records, you may elect to use a simplified method of $5 per square foot of the home office, up to a maximum of $1,500. Nevertheless, the actual expense method generally produces a bigger deduction and is often worth the extra work.

5. Higher education credits: Normally, parents with children in college may claim one of two higher education tax credits—the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Credit (LLC)—if certain requirements are met. Both credits are subject to **phase-outs** based on modified adjusted gross income (MAGI), but the rules vary slightly. For instance, the maximum AOTC is $2,500 per student while the maximum LLC is $2,000 per family. Compare the two credit choices.

What are your election results? Fortunately, you do not have to make these tough decisions on your own. Consult with an experienced tax professional early in tax filing season.

DOL Issues Final Rule on Worker Status
New guidance based on six factors

It is often difficult for employers to determine whether certain workers should be treated as employees or independent contractors. The determination could have broad implications for both employers and workers. Now the Department of Labor (DOL) has provided more clarity by issuing a new "final rule." This latest DOL guidance, which focuses on six key factors, takes effect on March 11, 2024.

Background: The classification of a worker's status under the Fair Labor Standards Act (FLSA) is critical as to the rights and responsibilities of the respective parties. For instance, if workers are treated as employees, this affects issues such as overtime pay, minimum wage requirements and eligibility for fringe benefits.

From a tax perspective, an employer must pay its share of payroll taxes on an employee's wages, withhold the employee's share of payroll taxes, and required income taxes, and report those amounts to the IRS. In contrast, if a worker qualifies as an independent contractor, the employer is relieved of those tax obligations. Thus, employers generally prefer to treat "borderline" workers as independent contractors.

However, if an employer improperly misclassifies an employee as an independent contractor, it could owe back taxes, interest, and penalties.

New guidance: Back in 2021, the DOL issued regulations on the classification of independent contractors, focusing on two "core" factors: the employer's right to control the worker's activities and the worker's opportunity for profit or loss. If both factors coincided—case closed. But the new final rule replaces the 2021 guidance with a more comprehensive analysis.

Notably, the DOL says that employment status will be based on the following six factors.

1. Opportunity for profit or loss depending on managerial skill. If a worker has no opportunity to impact profit or loss, they are more likely to be an employee than an independent contractor. But if a worker can make management decisions affecting profit or loss, the opposite is true.

2. Investments by the worker and the potential employer. If a worker purchases or provides equipment or tools needed to complete the work, this investment is generally indicative of an independent contractor relationship.

3**. Degree of permanence of the work relationship.** This factor favors employee status if the work relationship is indefinite in duration or continuous. Conversely, if the duration is definitive or project-based, the worker is likely to be an independent contractor.

4. Nature and degree of control. This previous core factor remains critical. It relates to whether the employer sets the worker's schedule, supervises the worker's performance, restricts their ability to work elsewhere or reserves the right to discipline the worker.

5. Extent to which the work performed is an integral part of the potential employer's business. This emphasizes whether the employee's function is integral to the business. The more integral the work is, the more likely the individual is an employee.

6. Skill and initiative. If the worker has developed specialized skills outside the usual scope of employment, it is more indicative of independent contractor status.

Be mindful that these factors are not all-inclusive nor is one more influential than another. The final rule requires employers to look at the "big picture" reflecting the totality of the circumstances.

What is the tax impact? Technically, the final rule only applies to the classification of independent contractors under the FLSA. But the IRS may take its cue from the DOL and seek consistency for tax purposes. This could lead to increased challenges for misclassifications. **Practical advice:** When in doubt, rely on assistance from your professional advisors.

Tax Shelter in Vacation Homes
How to bask in big tax benefits

Do you own a cabin in the woods or a cottage by the water? If you rent out the place when your family is not using it personally, you can generally claim deductions to reduce the resulting income tax liability. In fact, you might even qualify for a tax loss, but you must be careful to observe complex tax rules.

With the summer rental season fast approaching, now is the time to coordinate your tax strategies for 2024.

Background: Typically, a vacation homeowner can deduct the costs attributable to the rental to offset the income received from tenants, including mortgage interest, property taxes, repairs, utilities, insurance, etc. But there is a limit to this tax generosity. Under the passive activity loss rules, you can only use losses from a rental activity to offset losses from other passive activities.

However, if you are an "active participant" in the rental activity (e.g., you make management decisions and arrange repairs), the tax consequences for losses depend on your income level and the level of your family's personal use. There are three basic rules to follow.

- **If your income does not exceed $100,000**, you can use the loss to shelter up to $25,000 of your salary and other income as long as you keep your personal use to a minimum. Your family's personal use cannot exceed the greater of 14 days or 10% of the rental time. On the downside, when you keep your personal use below these limits, you lose a portion of your mortgage interest deduction (the portion allocable to your personal use).

- **If your income exceeds $150,000**, the tax law says you cannot qualify for the $25,000 loss write-off. Your total rental deductions basically cannot exceed your rental income, regardless of the amount of your personal use. However, if your personal use is greater than 14 days or 10% of the rental time, you are entitled to an additional deduction: the portion of your mortgage interest you do not claim as a rental expense.

- **If your income is between $100,000 and $150,000,** things are not as clear-cut. The $25,000 loss write-off is gradually phased out in this income range. The closer you are to the $150,000 level, the more likely it is you will get little in the way of a loss write-off. So, you will probably want to increase your personal use—the same strategy for those with incomes above $150,000. This way, you will be able to deduct more of your mortgage interest.

Conversely, if you are closer to the $100,000 level, most of your loss write-off will be intact. Therefore, try to keep your personal use below the 14-day/10% mark, if possible.

Note that the time you spend fixing up the place and preparing it for rental use does not count as "personal use" for these purposes even other family members tag along just to enjoy the great outdoors.

Reminder: The tax rules in this area are extremely tricky and it is easy to be tripped up. Do not hesitate to seek professional assistance regarding vacation home rentals.

Reporting on Beneficial Owners

The Financial Crimes Enforcement Network (FinCEN) is now accepting "beneficial ownership" reports. Under the Corporate Transparency Act of 2021, most companies operating in the U.S. are required to provide identifying information to FinCEN about the individuals who actually own or control them.

The deadline for this reporting, which began on January 1, 2024, is **January 1, 2025**, for companies existing before 2024. New companies formed after 2023 generally have **90 days** to meet the new reporting requirements.

The beneficial ownership information to be reported arises from determinations that are primarily legal in nature. For various reasons, including concerns regarding the potential for the unauthorized practice of law, Harper Pearson is unable to prepare these forms or assist clients in preparing these forms. We encourage you to contact legal counsel as soon as possible to determine how the CTA will impact your business.

FinCEN has released a Small Entity Compliance Guide and FAQs addressing reporting requirements. For more information, please visit FinCEN's website at https://www.fincen.gov/boi.

Facts and Figures
Timely points of particular interest

Open for Business—The tax filing season for individuals officially opened up on January 29, 2024. The IRS expects more than 128.7 million tax returns for the 2023 tax year to be filed by the April 15, 2024, deadline. But there is no sense in delaying matters until the last minute. Conversely, if you do need more time to collect information or for some other reason, you may obtain an automatic filing extension by making a request to the IRS by the April 15 deadline.

Still Working? —Generally, you must begin taking required minimum distributions (RMDs) from your qualified retirement plans and IRA after reaching a specified age threshold, depending on when you were born. The age threshold was recently upped from 70½ to 72 and again to 73. But you do not have to take RMDs from a qualified plan at a company where you are still working if you do not own more than 5% of the company. **Caveat:** This "still working" exception only applies to qualified plans—not IRAs.

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