

How to Double or Triple Your Tax-Free Rental Income

Are you receiving fourteen days of tax-free income from renting your residence? Very few doctors understand the tremendous value they can receive from it, as well as how to properly document and report it for income tax purposes.

Section 280A of the tax law covers the tax treatment of income and expenses involved with the business use of the doctor's residence and vacation homes. Section 280A(g), commonly known as the "Masters Rule," provides favorable tax treatment for rentals of less than fifteen days.

Under the rule, if a dwelling unit is used by the doctor as a residence and is rented for less than fifteen days during the year, the rental income received is tax-free. These rental days do not have to be consecutive, but can be scattered throughout the year. While no related rental expenses (depreciation, utilities, etc.) can be deducted, the doctor can continue to deduct itemized deductions such as home mortgage interest, property taxes, and casualty losses related to the residence.

For purposes of this rule, a dwelling unit includes not only a house, but also a condominium, apartment, mobile home, and even certain boats. That's right — a boat is treated as a dwelling unit as long as it contains sleeping, cooking, and bathroom facilities.

In order to qualify for tax-free income, the dwelling unit must be considered as a personal residence. That requires using the unit for personal purposes during the tax year for more than fourteen days, or 10% of the days rented out, whichever is greater.

Under the law, the doctor can use more than one dwelling as a personal residence and rent out each one for fourteen days every year. For example, if the doctor lives in his main home for ten months, his mountain cabin for thirty days and his beach/lake home for the other thirty days, each one would qualify as a residence under the law and could be rented out to receive tax-free income for up to fourteen days each year.

Value of Tax-Free Income

Doctors with more than one residence can easily double or triple their tax-free income under these rules, making this a tremendous wealth building strategy. For example, consider a doctor who rents both his personal residence and vacation home out for fourteen days each year and receives rental income totaling \$15,000. This tax-free income is equivalent to \$30,000 received as salary, for a doctor in the combined 50% federal and state marginal income tax bracket.

Thus, this tax-free income strategy saves the doctor \$15,000 in federal and state income taxes each year, making it far too valuable to pass up. Yet, most doctors fail to take advantage of it. Why? Simply because they don't know how to properly document and report it for tax purposes. —*Continued on Page 2*—

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Documenting Business Use and Rental Value

When the doctor rents his residence(s) out for 14 days or less to unrelated third parties who pay the going rate (fair market rental), most CPAs will properly treat the amount received as tax-free income. However, when the doctor rents his residence to his corporation, many CPAs will not report the transaction as tax-free income unless the doctor can document the corporation's business use and that the rent paid was at fair market value.

The key to showing appropriate business use is that the residence must be used by the doctor's corporation for business meetings, and not entertainment even if it includes patients and/or referring doctors. The corporation can use the doctor's residence for all types of business meetings, including board of director and shareholder meetings, business planning meetings, practice budgeting meetings, practice planning meetings, meetings with practice advisors (CPA, attorney, consultant, etc.), continuing education (including on line CE), retirement plan/investment meetings, staff meetings, and even Christmas/holiday parties for office staff. Doctors should document the actions taken during these meetings with minutes, which will not only benefit the practice, but also provide support for the business usage.

Obviously, the higher the rental fee paid by the corporation, the greater the tax benefit the doctor receives. Doctors should get a written quote from one or more hotel/ conference centers to determine the fair market rental for one day use of their meeting facilities with equivalent accommodations. Armed with proper documentation of the corporation's business use, and the related rental value, doctors will be able to claim the maximum benefit from the fourteen days of tax-free rental income.

Reporting the Income

Some doctors are stymied when their CPAs tell them that the rental income paid by the corporation to the doctor must be reported on Form 1099. The law does require that rental amounts paid in excess of \$600 to individuals must be reported to the recipient (and IRS) on Form 1099- MISC. However, while the income must be shown, taxes can be avoided by reporting it on the doctor's rental income schedule (Schedule E, Form 1040) as follows:

| | |
|---|-----------------|
| Rental income received | \$ 15,000 |
| Less: Amount tax-free under Section 280A(g) | <u>(15,000)</u> |
| | \$ 0 |

Source: The McGill Advisory, June 2016

IRA Rollover Rules

Did you know about the following IRA Rollover rules?

- A traditional IRA or a 401(k) can be converted into a Roth IRA. The conversion counts as taxable income, which can affect the Medicare Part B premium and the taxation of Social Security benefits. If large enough, the conversion can also push someone into a higher tax bracket.
- Roth 401(k) accounts are subject to required minimum distributions, but Roth IRAs are not. A Roth 401(k) can be rolled over into a Roth IRA tax-free.
- Employer-matching contributions must go into a traditional 401(k) account, even if the employee uses a Roth 401(k) account.
- A Roth IRA conversion cannot be used to avoid taking the required minimum distribution for the current tax year.