MONOTELO
ADVISORS

THE PURPOSE OF OUR WHITE PAPERS is to give our prospective clients the opportunity to hear the solutions we have recommended to address complex problems and to help people understand the issues to consider when making complex financial decisions. While the situations are real, the names have been changed to protect the innocent!

WHITE PAPER

INTRODUCTION

Our 1-2-3 case involves a husband and wife client of ours who received an unpleasant surprise when they filed their 2017 tax return. The husband and wife are both public servants, between them they are earning $225K per year. On top of this they received another $40K in interest and trust income during 2017. Anticipating a large tax bill, they decided to purchase a rental property and use the expenses they incurred to offset some of their taxable income and reduce their tax bill. During the year they spent $40K on the property. Based on advice they received from coworkers as well as another accountant they consulted, they believed they would be able to deduct this entire $40K on their 2017 tax return.

THE CHALLENGE

Unfortunately, when they came to us we had to tell them that not only could they not deduct the full amount, they would not be able to deduct any of their expenses on their current year return. There were 3 reasons they could not deduct the $40K they had been led to believe they would be:

1. **Cap on Losses from Rental Properties.** What this couple was not aware of when they decided to purchase this rental property to write off the expenses, is the $25K limit on rental property losses that can be deducted per year. This means that at least $15K of the $40K they spent would need to be carried forward to a future year. The only exception to this limit would be if one of them qualified as a real estate professional, which they do not as this property is the only activity they have in the real estate field.

2. **Capital Expenditures.** A large portion of the $40K came from improvements to the property preparing it for rent. These expenses cannot be deducted in the year they are paid but must be capitalized and depreciated over the useful life of the property, in the case of a residential rental property 27.5 years.

3. **Income Limit on Passive Losses.** The final nail in the coffin for this couple's rental loss deduction is they failed to realize there is a phase-out threshold for passive losses. Once a married couple, filing a joint return, have adjusted gross income above $150,000 they cannot take a loss for passive activities. Instead those losses are carried forward to future years until their income drops below the phase-out threshold.

THE SOLUTION

This couple was understandably not happy when we informed them that they would not be able to deduct any of the expenses they had incurred on the property on their 2017 tax return. They explained to us that one of the primary drives behind their purchase of the property was the tax break they expected to receive. Had they consulted with us during the year before making this purchase we could have warned them they would not be able to realize any tax breaks in the short term from the property and could have provided them with some alternative methods to reduce their tax burden for the year. By maxing out their respective deferred compensation accounts they could have reduced their taxable income by $16,000. Contributing to a Health Savings Account could have further reduced their taxable income by $7000. By failing to consult with us before making this decision they missed 3 red flags that show they would not be able to reduce their taxable income by purchasing this property. To avoid missing your own red flags be sure to seek counsel from Monotelo Advisors before making major investment decisions.

Failing to order your affairs to minimize your tax burden could cost you significant money – so don't wait to take action. If you have additional questions or need some planning help, please reach out to us.

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