Not Your Basic Bean Counter

Michael A. Gordon, CPA, LLC *www.mikegordoncpa.net*
290 S. 4th Street, Coos Bay, Oregon 97420 *541-269-1272*

INSIDE THIS NEWSLETTER

Converting Your Personal Residence Into A Rental?

We see this quite often. I want to alert you to a very common TRAP we see in this type of situation.

Here we go. Let’s set the stage with some facts (made up, of course). Mike and Rhoda bought their residence in 1990 for $250,000 down in Los Angeles. In January 2010 they moved up to Coos Bay. The housing market down there in Los Angeles wasn’t doing so hot in 2010. It didn’t appear that they could sell the house easily and it might even make some sense to wait until the market heated up again (fingers crossed). So, they decided to rent it out as of June 30, 2010.

WHAT IS THE LAW WHEN SELLING YOUR PERSONAL RESIDENCE?

It’s important to know what the IRS rules are or you WILL fall into the TRAP. Many people remember the OLD rules and even think that they still apply….but they don’t. So, what were the OLD rules? Those rules said that when you sold your residence you could avoid paying tax currently IF you bought a new one that cost at least as much as the old one. Remember those rules? The result under the OLD rules was that any gain got deferred into the new house. In other words, it was a timing issue at best. So, those rules were okay, but the new rules are much better.

The current rules say that if Mike and Rhoda sell their house in Los Angeles and the GAIN on the sale is less than $500,000 then there is NO tax to pay. Very nice, indeed.

BUT, WAIT….HERE COMES THE TRAP

THE TRAP is what we refer to as the “2 out of 5 year rule”. It says that you LOOK BACK 5 years from the date you sell the house and you must have lived in the house and used it as your personal residence for ANY 2 year period in that 5 year lookback time.

So, let’s take Mike and Rhoda and illustrate how this TRAP might just bite them in the rear (ouch!).

Mike and Rhoda avoid the TRAP

The Los Angeles market heated up and they were able to sell the house on

March 1, 2012, for $600,000. How does this pan out for tax purposes? After all, they rented the house out from June 30, 2010, through March of 2012. Are they doomed? Well, let's apply the rules and see how it shakes out.

Remember the rule….you look BACK 5 years from the date of sale. What was the date of sale? It was March 1, 2012. 5 years back takes us to March 1, 2007, right? So we look at the 5 year period from March 1, 2007, through March 1, 2012. Again, what do the rules say? Mike and Rhoda had to live in and use the house as their personal residence for ANY 2 years within that 5 year period.

Well…..did they? Of course they did. Let me convince you of that. For the 5 year test, they lived in it and used it as their personal residence from March 1, 2007, until June 30, 2010, when they rented it out. Right? That works out to 3 years and 4 months. It was rented after that for a total of 1 year and 8 months. Hopefully, you can see how I got those numbers.

So, let's keep going. They bought the house for $250,000 and sold it for $600,000. That works out to a gain of $350,000. Is it taxable? NO….because they met the "2 out of 5 year" rule.

Mike and Rhoda get hit by the TRAP

Okay….so now let's illustrate how bad this situation can get.

Mike and Rhoda didn't sell the house (for whatever reasons) until March 1, 2013….again, for $600,000. We have to run through the exact same rules as we did above. So, let's get to it.

You first look back 5 years from the date of sale. The date of sale was March 1, 2013, so we look back to March 1, 2008. Now, during that 5 year period how long did they live in it and use it as their personal residence? Well, they lived in it from March 1, 2008, and moved out January 1, 2010. How long is that? It's only 1 year and 10 months, right? THEY MISSED THE 2 YEAR RULE BY 2 MONTHS!!

So, what does this mean? It means that they will pay the tax on that $350,000 gain. How do you spell OUCH!

Had they come in and talked to their wonderful CPA early enough, they would have learned that they needed to sell their house at least 2 months earlier!

A COUPLE OF THINGS

I recognize that clients do not always call us before doing things. I get that. Obviously, I wish every client would...but, I understand. That's why I put these newsletters out. I hope this will help some of you.

Next, there ARE some rules in place that could make Mike and Rhoda pay a little bit of tax (even in the first situation). In addition, there are some rules in place that might get someone a "partial" exclusion if they missed the 2 year rule. These 2 rules are a bit complex and I didn't want to "muck" up the example. You get the main issue here…..the TRAP...that's what I wanted to get across.

Don't hesitate to call us if you have any questions about this issue.

MORE ON FRAUD AND INTERNAL CONTROLS

Taken from CAMICO Fraud Resource Center 2/29/16. CAMICO is my malpractice carrier. They are the best in the country and give their policyholders access to invaluable information….like this article!

Top 16 Tips for Avoiding Fraud

The most common method of fraud detection is a tip or complaint from an employee, vendor, customer or anonymous informant. Although small business frauds have a relatively low detection rate of fraud by audits, it does not accurately reflect the effectiveness of audits as deterrents to fraud by putting personnel on notice that a theft is likely to be detected.

The following list of practical loss prevention tips designed to prevent fraud from occurring has been compiled from a variety of sources.

Internal Controls

1. Separate the duties of receiving funds, disbursing funds, writing checks, signing checks, and reconciling bank accounts. Having one employee responsible for all cash-related functions makes small businesses vulnerable to fraud.
2. Have the monthly bank statement delivered unopened to the owner, who should review it for unusual transactions such as declining deposits and unfamiliar payees.
3. Owners should look for signatures or endorsements that look forged, missing checks, check numbers that are out of order, and checks where the payee listed does not match the name in the check register.
4. Consider an independent review of the cash accounts and bank statements by an anti-fraud specialist.

Employment Conditions

5. Institute background checks on new employees, and notify job applicants that their backgrounds will be checked.
6. Employees who receive regular and recurring training about the detrimental aspects of fraud are more likely to aid in controlling it.
7. Employees who feel well-treated and adequately compensated are less likely to commit occupational fraud than those who don't.
8. Employees who hold grudges against their employers—whether or not justified—are more likely to turn to occupational fraud and abuse.

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Workplace Conditions

9. Insist that employees take a vacation for at least one week every year and use that time to have the books reviewed for discrepancies.
10. Adopt a tip hotline or complaint-reporting mechanism that will enable employees, vendors, customers, or outside sources to report suspected fraud anonymously or without fear of reprisal.
11. Employers can gain valuable info by simply asking questions in a non-threatening, non-accusatory manner.
12. Conduct internal and external audits, especially a "fraud audit" instead of a "general audit" if you suspect fraud.

Automation

13. Have an accounting software program expert, preferably a CPA, do the initial set-up of the program to make sure that helpful features are turned on and unhelpful features are turned off.
14. Access to personnel and vendor master file records should be password protected and restricted by job function.
15. Computer systems should create an audit trail of all changes made to the vendor master file records, including an identification of those who made the changes.
16. Changes to vendor master file records should require supporting documentation, supervisory approval, and independent review.

Some Extra Tips From Mike (that's me)

1. The boss should be the one who reviews and signs each check and approves each invoice.
2. Set up security cameras if your business lends itself to this kind of scrutiny.
3. Have regular meetings (annually, quarterly, whatever) with key staff and ASK them specifically what they would do if they wanted to commit fraud and/or steal money or other property. You might be quite surprised what you will learn! When I was overseeing my father's large operation in Los Angeles (the optometry business) I used to do this regularly. I learned a lot! And I used that knowledge to improve our internal controls.

Top 50– Delinquent Taxpayers in Oregon

Ever wonder which people and businesses owe the most money in Oregon? Well, you can see for yourself! No kidding. The Oregon Department of Revenue has such a list on their website. Go to *http://www.oregon.gov/DOR/Pages/delinquent.aspx* and check it out!! There's a person listed in North Bend who owes $551,651.93…...there's also someone in Coquille who owes $934,243.50.

And, remember…..these are DELINQUENT taxpayers! It doesn't tell us HOW delinquent they are…..that would be interesting!

"Required Minimum Distribution" Rules

So, you have a retirement plan….like an IRA, a 401(k), a SEP IRA or a pension plan. You have had it for years. Did you know that the IRS is very interested in your plan?!

They say that you MUST start taking money out of your plan by the time you reach the grand old age of $70^{1/2}$. Now, you CAN put it off for one year, but then you have to take twice the amount in that second year.

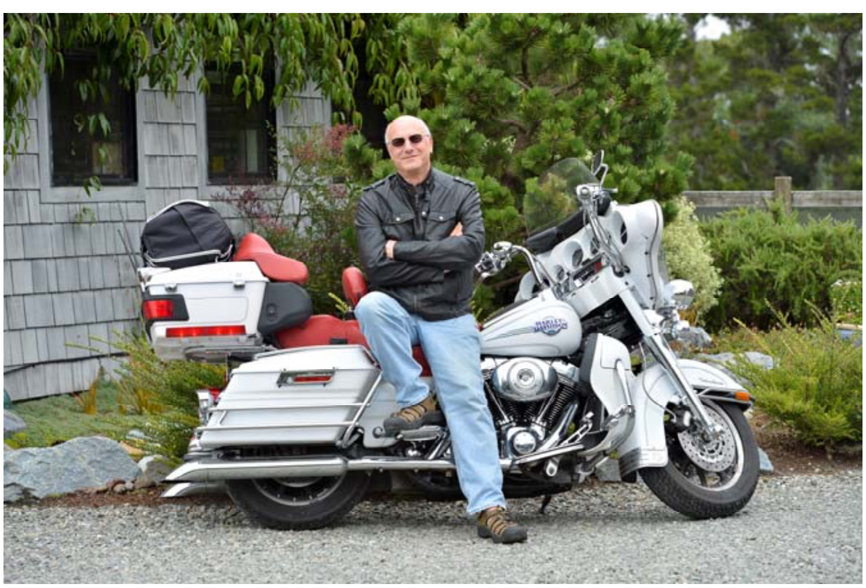
So, is there some rule about HOW much you have to take? Of course…..it's the IRS, remember. There are tables to use to determine exactly how much you must take annually. You can always take MORE, but you MUST take the minimum. That's why it is referred to as your "required minimum distribution".

How do you determine the exact amount to take out? Well, for practical purposes, whoever administers your retirement plan will do it for free. Good deal.

BOTTOM LINE: If you are turning $70^{1/2}$ some time in 2016, you want to contact your administrator and make sure you take out the minimum required amount before the end of the year. You CAN wait until 2017 if you want, but then you must take out twice as much in 2017 to make up for what was missed in 2016. You can only do this "catchup" once...and only in the second year. From then on, you gotta do it each and every year.

What if you have multiple accounts? You might have an IRA with one broker and a 401(k) with another. What then? Well, you have to take ALL of the accounts into the computation to determine the amount you need to distribute. In other words, you will NOT generate a "minimum distribution" for each account. It is all aggregated. There can only be ONE "minimum distribution".

CONFUSED? You aren't alone! Always feel free to call us with any questions.



This is me next to my OLD Harley Davidson Ultra Classic motorcycle. It is a 2005 model. I love to ride this on the coastal roads. We have the most beautiful roads and vistas along the 101. Then, we have thousands of miles of paved logging roads that are equally wonderful to ride on.

If any of you love to ride, give me a call and let's get out on some Saturday or Sunday for a few hours!!

CLIENT SPOTLIGHT

FRANK & MARLYNN ROLLINS

Frank and Marlynn moved here in March of 2015. They bought a home in Myrtle Point and then Frank started his business, which serves the entire Bay Area. We welcome them here! It's a great place to live.

Harbor Commercial Appliance Repair and Service, LLC

Frank's business provides repair and service work for kitchen appliances and equipment. He works exclusively on commercial applications. Frank says he likes to work on the "hot" side of food preparation….fryers, grills, mixers, and more. He has already provided outstanding repair and service work to many local restaurants, deli stores, retail stores, bars, grills, and even schools.

He prides himself on offering quality service at a reasonable price point.

Call him at 541-218-2419

Did you know??!!

Frank spent the better part of 22 years in the military as a combat control technician working with our special forces in several foreign countries. THANK YOU FOR YOUR SERVICE!!

Marlynn spent 25 years in Alaska where she had an airplane and a pilot's license. She did a lot of hunting, fishing and flying up there. Unfortunately, she sold the plane, so……….no joy rides for us!

Frank grew up in Lake Charles, Louisiana. Marlynn grew up in Fresno, California.