



Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business AdvisorSM

Deducting Interest Paid

February 2016



Among the itemized deductions on Schedule A of Form 1040, you'll find "Interest You Paid." As you get your records together for tax preparation, you should realize that not all interest can be deducted on your return. Interest you paid last year on credit card debt generally isn't deductible, for example.

Interest deductions on Schedule A fall into two categories. You probably can deduct interest on debt related to your home, and you might be able to deduct interest on debt you incurred as part of your investment activity.

Mortgage interest debt

If you have borrowed money to buy, build or improve your home, you can deduct some or all of the interest you paid during 2015. A "home" can be a house or an apartment you own—even a trailer

or a boat, as long as it has cooking, sleeping and toilet facilities. You can deduct the interest on two such homes.

Example 1: Warren Young owns a single-family home as well as a cabin on a nearby lake, which he uses on weekends. If Warren has mortgages on both homes, he typically can deduct all the interest he paid on those loans in 2015.

Going forward, suppose that Warren gets married in 2016, and his wife also owns a home. Assuming the couple files a joint income tax return in 2016, what mortgage interest can this three-home couple deduct?

They'll be limited to the interest paid on two homes. If one home is debt-free, the couple can deduct the interest paid on the two home loans. If all three homes are mortgaged, the couple can deduct the interest on the two homes with the highest interest payments during the year.

Home Equity Debt

In addition to home acquisition debt, there is a second category of debt, home equity debt, which may give rise to deductible interest. Interest on home equity debt, which includes loans secured by the home but not necessarily used for any specific purpose, is deductible

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Lower Score, Higher Cost

On a \$360,000 home purchase with a 20% down payment, a buyer with a 680 FICO credit score can pay over \$30,000 more in interest over the life of a 30-year loan than a buyer with a 740 score.

Trusted Advice

Naming names

- ❖ For many homeowners, mortgage interest will be reported annually to the IRS by the lender on Form 1098.
- ❖ However, that may not be the case if the seller “takes back” a loan, effectively lending part of the purchase price to the buyer.
- ❖ Assume the buyer makes monthly payments to the seller, on this loan. Payments include interest and some reduction of the principal.
- ❖ Then, the buyer probably will be entitled to deduct the interest paid.
- ❖ The buyer should put the seller’s name, address, and tax identification number on Schedule A of Form 1040.

for balances up to \$100,000 (\$50,000 for married taxpayers filing separately).

Example 2: Assume that Warren Young’s mortgages on his primary home and his vacation home total \$900,000, and Warren also has a home equity loan secured by his primary home of \$50,000. Warren can deduct all the interest he pays on both the mortgage loan and the home equity loan.

Million dollar limit

The deduction for interest paid on home acquisition debt is limited to interest paid on \$1.0 million of debt (\$500,000 for married taxpayers filing separately) and, as noted previously, the deduction for home equity debt is limited to interest paid on \$100,000 of debt (\$50,000 for married taxpayers filing separately). However, the IRS has ruled that it will treat home acquisition debt as home equity debt to the extent it exceeds \$1 million or \$500,000 for married taxpayers

filing separately, effectively increasing the limit on home acquisition debt to interest paid on \$1.1 million of debt or \$550,000 of debt for married taxpayers filing separately.

Example 3: Assume that Warren Young has an \$800,000 balance on his primary home mortgage plus a \$400,000 mortgage on his vacation home for a \$1.2 million total, and he has no home equity debt. Warren’s deduction on Schedule A would be limited to the interest paid on \$1.1 million of this debt. (If you are in such a situation, our office can calculate the allowable deduction.)

Don’t forget the AMT

The alternative minimum tax (AMT) rules for deducting mortgage interest are more restrictive than the regular tax rules. If you expect to be subject to the AMT, our office can determine whether the interest on home acquisition debt or home equity debt is deductible when calculating your AMT.

Investment interest

If you borrow money to make investments, the interest you pay on the loan may be deductible on Schedule A. Often, interest paid on a margin account at a brokerage firm will be classed as investment interest, but that’s not the only possible source. If you borrow to buy a parcel of land that you think will gain value, the interest you pay can be investment interest.

On Schedule A, investment interest can be listed up to the amount of taxable investment income you report.

Example 4: Stan Rogers had \$1,200 of taxable investment income from bond interest in 2015 and \$1,500 of interest on a margin loan. Stan can deduct \$1,200 of margin interest on Schedule A of his tax return for 2015, offsetting his \$1,200 in taxable investment income. The

unused \$300 of investment interest expense can be carried over to a future year in which Stan’s taxable investment income exceeds his investment interest expense.

Note that the situation would be more complicated if all of Stan’s 2015 investment income came from dividends instead of interest. Assuming those dividends qualify for low tax rates of 0% to 20%, which generally is true, the dividends would not count as investment income for this purpose. In this situation, Stan could not deduct any of his investment interest expense.

However, Stan could elect to treat his dividends as nonqualified, which are taxable at higher rates. Then, Stan could deduct his investment interest expense.

Net capital gains (that is, net long-term capital gain less short-term capital losses) from the disposition of investment property are also not included in investment income. Like dividends, a taxpayer may elect to have net capital gains included in investment income, but the gains included in net investment income will be taxed at the higher ordinary tax rates.

There are times when electing to include dividends or net capital gains in income makes sense; if you have that choice, our office can help you make the most tax-effective decision. ■

Did You Know?

Among students who began their studies full-time at a four-year institution in 2007, about 40% had completed bachelor’s degrees at their first school after four years. About 60% had completed their degrees after six years. Thus, among students who earned bachelor’s degrees within six years, one-third took more than four years to do so.

Source: The College Board

The IRS May Put You on Hold



During the tax preparation season, business owners, individual taxpayers, and CPAs may have questions for the IRS. If you need to call the agency, be prepared for a long wait. Increased tax code complexity plus budget cuts have resulted in frustrating experiences for many callers.

Advocate's assessment

In her latest report to Congress, National Taxpayer Advocate Nina E. Olson noted that the number of taxpayer calls routed to "telephone assistants" increased by 41% during last year's filing season. Yet the number of calls answered by those phone assistants decreased by 26%.

The number of "courtesy disconnects" received by taxpayers calling the IRS skyrocketed from about 544,000 in 2014 to about 8.8 million in 2015. A courtesy disconnect occurs

when the IRS essentially hangs up on a taxpayer because its switchboard is overloaded and cannot handle the call. For those callers fortunate enough to get through, hold time averaged 23 minutes last year.

Tax professionals ran into similar problems. The IRS has a Practitioner Priority Service line, to answer questions from CPAs and other tax preparers. In the 2015 filing season, the IRS answered only 45% of such calls, with hold times averaging 45 minutes.

More questions, more time

Why did incoming calls spike by 41% last year? Olson pointed out that the IRS "sharply restricted the availability of paper copies of forms and publications, imposing burden on taxpayers without Internet access or online literacy." Without paper forms and publications, more people called in.

Olson's report also mentions that the IRS had to implement large portions of the Affordable Care Act and the Foreign Account Tax Compliance Act. Both laws, passed in 2010, contain provisions that raise questions for taxpayers, and those questions

apparently soared last year after delayed provisions went into effect.

Cost cutting

As demands on the IRS have risen, the agency's budget has fallen. In 2015, the federal General Accountability Office (GAO) reported that IRS total appropriations declined from a high of \$12.1 billion in fiscal year 2010 to \$11.3 billion in fiscal year 2014, with an additional \$346 million decrease from fiscal year 2014 to fiscal year 2015. As of this writing, still more funding cuts appear to be in store for the 2016 fiscal year.

According to the GAO, some IRS business units have responded to the budget reductions by reducing staff by 16% to 30%.

Grim outlook

For the 2016 filing season, neither a decline in complexity nor an increase in IRS funding can be expected. Therefore, callers to the IRS likely will once again face difficulty getting through to the agency. Rather than trying to deal with the IRS, you can call our office with your questions and concerns. ■

Portability in Estate Planning

The federal estate tax exemption for deaths in 2016 is \$5.45 million. Married couples may be able to pass twice that amount—\$10.9 million—to their heirs without triggering estate tax. Some planning is necessary to reach the higher level, but a relatively new tax code provision, known as *portability*, can simplify the process.

Traditional tactics

For decades, estate tax planning for married couples with substantial net

worth involved asset shifting and trust creation.

Example 1: George Hall owns a small business valued at \$4 million. George's other assets (real estate, retirement plans, investments, etc.) total \$3 million. If George dies and leaves everything to his wife, Irene, no estate tax will be due. Bequests to spouses usually avoid estate tax.

In this scenario, Irene will inherit George's \$7 million estate. Including the proceeds from a life insurance

policy and her own wealth, Irene might have a net worth of \$10 million.

Assuming Irene dies with that \$10 million a few years later, when the estate tax exemption has risen to \$6 million, her estate would be \$4 million over the limit. With the current 40% estate tax rate on nonexempt assets, Irene's estate would owe \$1.6 million in federal estate tax (40% of \$4 million), reducing the net payout to the Halls' children, who are Irene's heirs.

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To avoid this tax, the Halls might set up trusts, to receive some assets at the first spouse's death, untaxed because of the estate tax exemption. George also might shift some assets to Irene, so that a tax-effective trust could be funded regardless of which spouse is the first to die.

Easier does it

Recently, the concept of estate tax exemption portability has been introduced to the Internal Revenue Code. Under the portability rules, the surviving spouse can use the decedent spouse's unused estate tax

exemption if the executor of the decedent spouse's estate makes a portability election on the decedent spouse's estate tax return. Trusts and asset transfers can still be used, but they may not be necessary.

Example 2: George Hall keeps his \$7 million in total assets, which he leaves to Irene, as in example 1. At his death in 2016, the executor of George's estate files a federal estate tax return, IRS Form 706, making the portability election.

In example 2, George has used none of his estate tax exemption, so all \$5.45 million is transferred to Irene. If

she dies in a year when the exemption amount is \$6 million, Irene will have an \$11.45 million federal estate tax exemption: her own \$6 million plus \$5.45 million from George. (These examples all assume that neither spouse made any taxable gifts.) If Irene dies with \$10 million in net worth, her \$11.45 million exemption will allow it all to go to their children, free of federal estate tax.

Our office can help you determine whether using portability makes sense in your overall wealth transfer planning. ■

TAX CALENDAR

FEBRUARY 2016

February 1

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2015. Payments that are covered include: (1) compensation for workers who are not considered employees; (2) dividends and other corporate distributions; (3) interest; (4) rents; (5) royalties; (6) profit-sharing distributions; (7) retirement plan distributions; (8) original issue discounts; (9) prizes and awards; (10) medical and health care payments; (11) debt cancellations (treated as payment to debtor); (12) payments of Indian gaming profits to tribal members; and (13) cash payments over \$10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2015.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2015 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2015. Deposit or pay any undeposited tax. If your tax liability is less than \$2,500, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2015. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

February 16

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2015. Payments that are covered include: (1) amounts paid in real estate transactions; (2) amounts paid in broker and barter exchange transactions; and (3) certain payments to attorneys.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the

monthly rule applies.

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

February 17

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2015, but did not give you a new Form W-4 to continue the exemption for 2016.

MARCH 2016

March 15

Corporations. File a 2015 calendar-year income tax return (Form 1120) and pay any tax due. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporations. File a 2015 calendar-year income tax return (Form 1120S) and pay any tax due. Provide each shareholder with a copy of Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic six-month extension of time to file the return, file Form 7004 and deposit what you estimate you owe.

S corporation election. File Form 2553, Election by a Small Business Corporation, to choose to be treated as an S corporation beginning with calendar year 2016. If Form 2553 is filed late, S corporation treatment will begin with calendar year 2017.

Electing large partnerships. Provide each partner with a copy of Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership, or a substitute Schedule K-1. This due date applies even if the partnership requests an extension of time to file the Form 1065-B by filing Form 7004.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in February if the monthly rule applies.