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INDIVIDUAL TAX PLANNING

Home Interest Expense: Tips and Traps

For many, one of the most significant income tax deductions is their home mortgage interest. But this important deduction comes with a number of traps, as well as several opportunities. Here's a refresher on that topic.

Home Acquisition Debt

The tax law actually permits the deduction of interest associated with two home mortgages: your principal residence and one other secondary residence. The debt proceeds must have been used to acquire, construct or substantially improve the residence, and the debt must be secured to that residence. This latter requirement of having the debt secured to the property can be a problem with family financing.

Example. Phil, a 28-year-old, is acquiring his first home and borrows part of the acquisition funds from his parents on a private note. The funds borrowed from his parents allow Phil to have a sufficient down payment to secure a better interest rate on the first mortgage from his bank. Both the bank mortgage and Phil's note to his parents are acquisition debt, as the proceeds trace to the purchase of his home. But Phil's interest expense on the note to his parents is nondeductible unless his parents secure that note by recording it at the county courthouse.

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The Two Residence Limit

The home acquisition interest deduction is limited to the taxpayer's principal residence and one other residence selected by the taxpayer that is used personally, such as a seasonal vacation home. The general test of personal use is 14 days within a year, or 10% of the number of days that the property is rented, whichever is greater. Personal use includes days of use by family members.

For those with multiple homes, the key is to identify the secondary residence with the greatest interest expense. Interestingly, this residence can be a mobile home, boat or house trailer, as long as the property contains sleeping space, toilet and bath facilities, and cooking or kitchen equipment. As a result, that expensive recreational boat, with the proper facilities, can qualify for deductible interest as a second home.

The \$1 Million Limit

Home acquisition interest, whether for one or two residences, is subject to an overall \$1 million debt limit. If the combined debt on the principal and second residence exceeds that amount, only the allocable portion of the interest expense attributable to the first \$1 million of debt is tax deductible.

Home Equity Debt

In addition to deducting the interest attributable to residential acquisition debt, a taxpayer is permitted to deduct interest on up to \$100,000 of home equity debt. Home equity debt is defined as any debt secured by a qualified residence that is not acquisition debt. The home equity debt privilege is valuable, as it allows a taxpayer to achieve deductibility of interest on debt used for personal items (otherwise nondeductible), such as vacations, gifts to family members, retirement of credit card debt, etc.

It is possible for a single loan to represent both acquisition debt and home equity debt. But the home equity portion of the proceeds must be used for purposes other than residential acquisition, construction or substantial improvement.

Example. Sue has a home that has appreciated substantially. She decides to refinance her mortgage to secure more favorable terms, and also to use the equity in her home to obtain additional funds for a new vehicle and to assist with her children's education. Sue's residence presently has a \$300,000 secured acquisition debt. Sue refinances that debt with a new mortgage for \$380,000. She uses the extra \$80,000 of proceeds for vehicle and education purposes. \$300,000 of this mortgage is acquisition debt, and \$80,000 is qualified home equity debt. Accordingly, Sue may deduct all of the interest expense on this debt.

Example. Ed purchases a new principal residence and incurs \$1.4 million of acquisition debt. Ed is limited to using \$1 million of this mortgage for tax deductible interest purposes. He cannot consider \$100,000 of this \$1.4 million loan as home equity debt, because all of the proceeds trace to acquisition of the property. Home equity debt cannot be acquisition debt.

Deductible Points

For most taxpayers, points and fees associated with new debt must be amortized over the term of the loan. However, a special rule allows points on a principal residence acquisition or improvement debt to be deducted when paid. Points represent a charge of the lender, and are often listed on the closing statement as a loan origination fee or loan discount. The taxpayer needs to pay these points from cash at closing; they cannot be borrowed from the lender.

But points on debt associated with a second residence (i.e., a vacation home) are not an immediate deduction. They must be amortized ratably over the term of the mortgage. Similarly, points on a refinanced home mortgage, including a principal residence mortgage, must be amortized over the term of the debt.

BUSINESS TAX DEVELOPMENTS

IRS Scrutiny of Section 1031 Exchanges

The Treasury Inspector General has issued a critique of potential abuses associated with the popular Section 1031 tax deferred exchange technique. This review suggested that the IRS should be increasing its enforcement of possible abuses and errors on real estate exchanges. The Treasury Release noted that Section 1031 exchanges have become increasingly popular, and with this activity there are indications that some exchanges are being conducted improperly. So, on the premise that we are moving toward increased IRS scrutiny, here are some points to consider:

Section 1031 exchanges are designed to allow a business or investor to dispose of one property and replace it with another without incurring current taxation. The gain on the original property is not eliminated, but simply defers into the replacement asset. Thus, Section 1031 exchanges are not a tax elimination technique, but rather a tax deferral strategy.

Most exchanges today are done with the use of an independent party known as a qualified intermediary (QI). The QI closes the sale of the relinquished property for the taxpayer, and holds the cash awaiting directions on reinvesting the sale proceeds in one or more replacement properties. The use of a QI allows a deferred exchange: The exchanger's property is disposed of, but that taxpayer is allowed a period of time to reinvest the sales proceeds to complete the exchange. However, there are some rigid deadlines that must be met.

The Replacement Deadlines

One of the concerns identified in the recent Treasury release was noncompliance with the two deadlines associated with a deferred exchange conducted through a QI. When a seller moves property to a QI to start the exchange process, two deadlines begin ticking. The first is a 45-day identification period. Within that timeframe, the seller must identify one or more replacement properties that are under consideration to complete the exchange. This is simply a written notification to the QI, but it is an absolute requirement to accomplish a successful 1031 exchange.

The second deadline is the 180-day closing requirement. Under this rule, the replacement property must be acquired and transferred to the seller to complete the exchange within 180 days. There is no ability to extend this time limit.

Qualified Replacement Property

Section 1031 has liberal rules regarding the definition of “like-kind” real estate for exchange purposes. Improved property containing buildings can be exchanged for unimproved investment or agricultural land, and different categories of property may be exchanged (residential rental for commercial real estate, for example). But the Treasury study suggests that abuses are occurring with taxpayers attempting to stretch this rule to include vacation and other personal use properties.

A recent court case pointed out that a seasonal vacation home, because of its personal use, does not fit the “business or investment” requirement of Section 1031. The taxpayer argued that the property had inflated and was an investment, but this was dismissed by the court in view of the taxpayer’s personal use of the lake cabin (*Moore*, TC Memo 2007-134).

The Merits of a Section 1031 Exchange

Tax deferral, especially for long periods of time, can be very valuable. In fact, if the real estate received in the exchange is held for the taxpayer’s lifetime, the capital gain tax may never be paid. This occurs because property that passes through an estate receives a fresh tax cost equal to its market value. This eliminates the deferred capital gain, and the heirs of the decedent can sell the property without any income tax recognition (assuming the property is sold shortly after the estate before further appreciation occurs).

But in other cases, a Section 1031 exchange takes place, and the replacement property might be sold within the near term. In these cases, the gain has only been deferred for a short period, and this raises the question of the wisdom of doing the earlier Section 1031 exchange. An exchange requires fees, and a short term deferral may not be efficient.

Further, today's capital gain rates are at an all-time low. Some of the leading presidential candidates have indicated that it is their intent to increase the capital gain rate from its present 15%, suggesting rates ranging from 20% to 28%. History tells us that capital gain rates have ebbed and flowed with political changes in Washington. Given the dynamics of the 2008 elections, accomplishing an exchange today that defers a gain to the near future, where higher capital gain rates might apply, may not be advantageous.

FINANCIAL PLANNING

Revisiting College Savings Plans

Beginning in 2008, the infamous Kiddie Tax will apply the parents' top tax rate to the investment income of a child between the ages of 18 and 23, who is in student status. The ugly surprise will be that when parents begin to cash in mutual funds, U.S. savings bonds and other investments that have been dutifully saved for post-secondary education costs, those gains and earnings will be taxed at the parents' top bracket even if the investment is owned by the child. For those with younger children, it now makes even greater sense to build their college savings through a 529 state-sponsored plan.

Section 529 Plans

These plans are named after a section of the Internal Revenue Code that provides their tax-favored status. Section 529 plans are state-sponsored and come in two flavors: prepaid tuition programs and traditional college savings accounts.

The prepaid tuition plans are generally best suited for those who expect the child to attend a public university or college within the state. The growth of the investment is tied to the rate of tuition increase in the state's college system, but that rate of return generally diminishes if the funds are withdrawn for use in an out-of-state or private university.

The other version, the college savings account, is more popular and more flexible. In these arrangements, a sponsoring state will pair up with one or more mutual fund companies, and offer a mix of investments in mutual funds, ranging from conservative bond funds to aggressive equity funds or a mix thereof. These plans generally allow the withdrawals to be used at any institution, public or private, in-state or out-of-state.

The key tax feature is that the earnings and appreciation in both types of plans are entirely tax-free, assuming the funds are withdrawn for higher education costs. These costs include tuition, fees, room, board, books and supplies for attendance at an accredited higher education institution. Withdrawals are tax free if used for these costs, and that avoids the Kiddie Tax and any other form of federal or state income taxation.

But there are additional features that make these plans advantageous.

Beneficiary Flexibility

One of the key advantages of 529 plans is the ability of the owner to maintain control of the investments (within the parameters of the various fund choices offered by the particular 529 plan). Further, the owner retains the ability to designate a change in the beneficiary. When a 529 plan is established, it is considered a gift from the owner who establishes the plan to the initial designated beneficiary. This means that if the owner passes away, the funds are considered as if they are already transferred, and are not part of the estate of the donor-owner. And yet the owner retains control of both the investment decisions and any future changes in the beneficiary. This makes these plans ideal for grandparents who are interested in reducing their estate and helping with the higher education costs of grandchildren.

Example. Bill and Marie are grandparents with a sizeable estate. They have been regularly making gifts to their children, but have not made any outright gifts to their grandchildren because of concerns about how they might use those funds when they reach legal age to control the assets. Bill and Marie can each contribute up to \$12,000 per year to a Section 529 plan for each grandchild, with no gift tax reporting or other tax consequences. They identify themselves as the owner and a grandchild as the beneficiary of each account.

If Bill and Marie wish, they can fund a larger \$60,000 amount for each grandchild in a single year, applying a special 529 election to use five years of annual gift exclusions to fund each account (although this strategy requires the filing of a gift tax return). Bill and Marie have effectively jump-started the 529 plan for each grandchild with a major investment of \$60,000 that grows tax-free and also is outside of their estates.

Changing the Beneficiary

The tax law allows surprising flexibility with respect to the ability to change the beneficiary of a 529 plan. The replacement beneficiary simply must be a member of the family of the original beneficiary. The definition of “family member” is very broad, extending to descendants, cousins and a broad array of in-laws, as well as closer relationships.

Example. Assume that Bill and Marie, in the previous example, have set up a Section 529 plan for each grandchild. When their oldest grandchild reaches college age, he can throw a 95 mph fastball, and receives a full-ride baseball scholarship to a major university. Because his 529 account is not needed for higher education costs, Bill and Marie change the beneficiary designation to another family member. This change could extend to a first cousin of the original beneficiary (i.e., a grandchild of Bill and Marie who is the son or daughter of one of their other children). There are no further gift tax implications if the replacement beneficiary is of the same or older generation as the original beneficiary.

This beneficiary flexibility can also be valuable when the grandparents establishing the 529 plan have an unequal number of heirs among their children. For example, as grandparents are setting up 529 plans for each grandkid, they may have a child who does not have any children at present. In this case, to keep their gifts in proportion, the grandparents can establish a 529 plan naming their child as the initial beneficiary. When that child has his or her own children, they can change the beneficiary to those grandchildren.

Selecting the Plan

An individual can open a 529 plan in any state, but as general rule, check out the plan for your state of residence first. Many states will subsidize the investment for in-state investors with a match, or perhaps provide an income tax deduction on the state income tax return. After those possibilities have been investigated, an investor considering a 529 plan should look at other state alternatives. When looking at the variety of state plans, consider the mix of underlying funds offered by the particular state plan, their cost and investment performance.

Families have clearly recognized the distinct advantages offered by 529 plans, as there is now in excess of \$100 billion invested nationwide. With the 2008 Kiddie Tax facing most college students, these plans become even more important. If we can assist with how a 529 plan might fit your situation, please contact us.