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assets

a business, tax, and financial newsletter

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Are you dreaming of a mountain cabin or an oceanfront bungalow hideaway? Then you may want to consider that a vacation home can offer some tax savings. Whether you choose to use the home solely for enjoyment or combine business and pleasure by renting the property part-time, it is important to understand the tax laws for a second home.

As long as the combined debt secured by the vacation home and your principal residence does not exceed $1.1 million, you can deduct all of the interest paid on a mortgage used to buy a second home. This advantage is restricted to two homes. Should you purchase a third home, interest on that mortgage is not deductible. However, regardless of how many homes you have, you may be able to deduct all of the property tax paid.

One break enjoyed by homeowners—the right to immediately deduct points paid on a mortgage—applies only to a principal residence. Points paid on a loan for a second home must be deducted gradually, as the mortgage is paid off.

Personal Residence

Your vacation home is considered a personal residence if you rent it for no more than 14 days a year. In such a situation, you may retain the rent tax free without jeopardizing your mortgage interest and tax deductions. However, you may not deduct any rental-related expenses. If you rent out the house on a continual basis, things may become more complicated. Depending on the breakdown between personal and rental use, different rules may apply.

If you buy primarily for pleasure but rent for 15 days or more, the rent you receive is taxable. Because the house is still considered a personal residence, you may deduct all of the interest and property tax. You may also be able to deduct other rental-related expenses, including the cost of utilities, repairs, and insurance attributable to the time the house is rented. In some cases, you may be able to deduct depreciation. When the house is considered a personal residence, rental deductions cannot exceed the amount of rental income you report. In other words, your second home cannot produce a tax loss to shelter other income. In most cases, the interest and taxes assigned to the rental use of the house combined with the operating expenses more than offset rental income, thus limiting your ability to write off depreciation.

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It's Later Than You Think: Do You Know Your IRA Basis?

With the rising popularity of **Individual Retirement Accounts (IRAs)**, many people may have been making yearly contributions without giving much thought to what will happen from a ***tax standpoint*** when they start taking money out of their traditional IRAs. This oversight is understandable, since many IRA contributors may be years away from retirement, and ***contributions,*** not withdrawals, are usually the primary focus.

However, when you begin taking distributions from a traditional IRA, a variety of tax issues could arise. In general, your distributions are included in your gross income. Withdrawals made before the age of 59½ are subject to a 10% penalty, in addition to ordinary income tax. This process is relatively straightforward for those who have made only deductible contributions to their IRAs, but taxation is more complicated for nondeductible contributions.

IRA Tax Basis

If all of your contributions to a traditional IRA were deductible, then you have no **basis** in your IRA, and your distributions are fully taxable. Basis represents the after-tax balance in your account. If you made nondeductible contributions to your IRA, the amount of your contributions equals your basis, and this money is not subject to tax upon distribution.

Deductible Contribution Limits

Prior to 1987, all wage earners could make a deductible contribution of up to $2,000 annually. But, the Tax Reform Act of 1986 limits deductible contributions for employees who are active participants

in qualified employer-sponsored retirement plans with **adjusted gross income (AGI)**—subject to certain modifications—exceeding specified amounts based on filing status. ($62,000–$72,000 for single filers; and $99,000–$119,000 for married joint filers in 2017).

Nondeductible Contributions

While some people were aware that a nondeductible contribution was permitted without regard to active participation in an employer-sponsored plan, many who made such nondeductible contributions failed to account for them by filing Form 8606 with their annual tax returns. Form 8606 properly tracks nondeductible IRA contributions in both ***current*** and ***prior*** tax years, and is the only official record of after-tax contributions (i.e., IRA basis).

Without having filed Form 8606 for years in which nondeductible contributions were made, a taxpayer will be exposed to double taxation of contributions when withdrawals are made. According to the IRS, without the proper historical record, no distinction is made between contributions made with ***before***- and ***after***-tax dollars, and all withdrawals are subject to taxation. In addition, there is a $50 penalty for failing to file Form 8606 for any year in which nondeductible contributions were made.

Also, consider state taxation of IRA withdrawals. Many states do not permit deductions for IRA contributions and, consequently, provide for a tax-free "return of basis." This means that contributions are not taxed when withdrawn, but that part of the IRA account, consisting of accrued interest and dividends, is then taxed as received. However, this "return of basis" works only if the individual has kept accurate records and knows what his or her IRA basis is.

Recordkeeping

One way to determine your total deductible and nondeductible contributions is to examine your tax returns over the entire period of IRA funding. If your recordkeeping has been less than ideal, account trustees (insurance companies, banks, mutual fund companies, brokerage firms) may be able to help you reconstruct your total contributions over the years. However, be advised that such trustees usually have no record of whether your contributions were deductible or nondeductible.

If you find yourself in "IRA limbo" with respect to your IRA basis, you may want to enlist the help of a qualified professional. Remember, it is important to keep organized records of your contributions and to file the appropriate forms. However, to help avoid a tax mishap at the time of withdrawal that could undo some of the annual benefits you have enjoyed from tax-deferred savings, be sure to consult your tax professional about your unique circumstances. ■

a vacation home: the ultimate hideaway

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Rental Property

Now consider your tax situation if you buy a property primarily as an investment and limit your personal use of the property to 14 days a year (or 10% of the number of rental days, whichever is greater). Because the house is a rental property according to the Internal Revenue Service (IRS), your deductions can exceed the amount you receive in rental income.

If your rental income does not cover the cost of renting the house, you may be able to claim a taxable loss. Rental losses are classified as passive and can be deducted only against passive income, such as that from another rental property that realizes a gain. If you do not have passive income to shelter, the losses have no immediate value; however, unused losses can be used in the future when you have passive income.

There's an exception to this rule, however, that permits taxpayers with adjusted gross income (AGI) under $100,000 ($50,000 if married filing separately) to deduct up to $25,000 ($12,500 if married filing separately) of passive losses against other kinds of income, including salaries. To qualify, you must actively manage the property. The $25,000 allowance is gradually phased out for taxpayers whose AGI is between $100,000 and $150,000.

If your vacation home is considered a rental property, the mortgage interest attributable to the time the premises are rented is a business deduction. The remainder cannot be deducted as home mortgage interest since the house doesn't qualify as a personal residence.

These tax laws also apply to apartments, condominiums, mobile homes, or boats with basic living accommodations. Generally, these are considered rental properties if they include a sleeping space, bathroom, and cooking facilities. If you are considering the purchase of a vacation home, keep in mind that, from a tax perspective, that mountain cabin or oceanfront bungalow may be the ultimate dream home. ■

Increasing the Value of Charitable Gifts

Do you regularly make substantial gifts to a favorite charity? If so, you may be interested to know you can boost the value of your contribution by giving **life insurance** instead.

Life insurance has long been recognized as an effective estate planning tool. The key concept is that you pay fewer dollars today (in the form of premiums), and your heirs receive a potentially large death benefit upon your death. This same planning mechanism can be applied to charitable gifts, as well.

For example, suppose an older couple, the Harrisons, make an annual gift of $11,000 to a favorite charity. Rather than gifting $11,000 in cash to the charity each year, the Harrisons can leverage their gift and pay the premium on a **survivorship life insurance policy** instead. This insurance gifting program is arranged so the charity owns and is the beneficiary of the new survivorship policy (subject to state insurable interest laws).

The Harrisons could then take an annual charitable deduction for their generous gift, and the charity will ultimately receive a potentially substantial life insurance death benefit.

Charitable life insurance gifts can be a creative method for enhancing regular cash gifts. However, as with all tax planning matters, a qualified professional should be consulted to ensure your planning decisions are consistent with your overall goals and objectives. ■

Estate Planning: A Team Effort

Estate planning often involves a team consisting of an attorney, a financial professional, an insurance professional, and yourself. However, whether you are establishing a new estate plan or revising an existing one, only *you* can provide the guidance, direction, and information your estate planning team needs to develop an effective plan.

Most estate planning efforts begin with a questionnaire and an asset inventory. Although the process may seem cumbersome, the more complete the information you provide, the better equipped your team will be to help you achieve your goals. Even questions that seem intrusive at first have specific purposes. Following are some examples of the kinds of estate planning information you may be asked to provide:

Assets and Liabilities. A list of your assets, their estimated net value, and documentation of the form of ownership (individual, joint tenancy, tenancy by the entirety, and other forms of co-ownership). You will also need to identify your liabilities and those of your spouse. If you live, or have ever lived, in a community property state, you will need to provide information to separate your individual and community property and to determine who is responsible for the management and control of community property.

Family and Other Beneficiaries. The names, ages, relationships, and special needs of family members and other beneficiaries. A copy of property settlements, other financial agreements, and court decrees from any prior marriages of both you and your spouse.

Existing Estate Plans. A copy of your current will, along with information on any contractual or legal restrictions on the disposition of your assets. In addition, documentation of survivorship provisions and beneficiary designations on insurance policies, retirement plans, employee benefit plans, business buy-sell agreements, and other such assets.

Health Status. Information on your current health status and that of your beneficiaries. Also, the average life spans of your ancestors and their ages at death.

Objectives and Purposes. Your objectives, purposes, and hopes for yourself and each beneficiary, along with an assessment of each beneficiary's ability to manage money.

Benefits of Team Work

Once fully informed, your estate planning team can assist you in several important ways. They can: 1) Analyze your assets to determine which you should dispose of during your lifetime, which you should retain, and whether any special expertise may be required to

value and dispose of your assets; 2) Identify which assets may be subject to probate and estate taxes and estimate the potential shrinkage due to these costs; 3) Estimate and plan for the liquidity (cash) needs of your estate, your surviving spouse, and other family members and beneficiaries (for instance, cash may be needed to help cover estate taxes, probate costs, or for income replacement); and 4) Guide you in selecting the best domicile—assuming you have a choice—to help reduce the net effect of taxes on your estate.

No Plan is Final

Bear in mind that no estate plan is permanent. Marriages, remarriages, births, deaths, new employee benefits, and legislative changes may all necessitate adjusting an existing plan or creating a new one. Also, the composition of your assets may change over time. You can keep your estate plan up-to-date by notifying your estate planning team of any relevant changes as they occur, and by responding when they alert you to legislative changes that may affect your estate.

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