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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

June 2011

June is known traditionally as a popular month for weddings, so we thought the June issue of *Tax and Business Alert* would be a good place to mention a tax-saving opportunity available to newlyweds as well as other taxpayers.

One of the most common large-scale financial transactions most of us encounter is the sale of our home, and newlyweds have a unique opportunity to exclude home sale gains. As background, taxpayers are allowed to exclude from federal taxation up to $250,000 ($500,000 if married filing jointly) of gain realized on the sale or exchange of a principal personal residence. Gain is computed based on the selling price less the adjusted cost basis of the residence plus any selling expenses.

Married taxpayers filing a joint return for the year of sale may exclude up to $500,000 of gain if (a) either spouse owned the home at least two of the five years prior to the sale, (b) both spouses used the home as a principal residence for at least two of the five years prior to the sale, and (c) neither spouse is ineligible for the exclusion because he or she had sold another home within the two-year period ending on the sale date to which the exclusion applied.

Home Sales by Newlyweds

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If only one spouse meets the qualifications of items (b) and (c), that spouse may still be entitled to exclude up to $250,000 of gain on the joint return. When only one individual entering a marriage owns a principal residence, close attention to the calendar and to usage by the nonowning spouse can make the difference between a completely tax-free and partially taxed gain.

If both parties entering a marriage intend to move into a new (to them) principal residence after their marriage, each can sell his or her former residence and exclude up to $250,000 of gain if they each meet the three qualifications. The provision limiting the exclusion to only one sale every two years by the taxpayer does not prevent a husband and wife from filing a joint return and each excluding up to $250,000 of gain from the sale or exchange of each spouse's principal residence owned at the time of marriage. However, this is only the case when

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Tax Freedom Day®

According to the Tax Foundation, Tax Freedom Day® was April 12, the 102nd day of 2011. This is an indication that taxpayers worked more than three months before they earned enough money to pay this year's federal, state, and local taxes. Tax Freedom Day® arrived three days later in 2011 than it did in 2010, but nearly two weeks earlier than in 2007. The Tax Foundation estimates that Americans will pay more in taxes in 2011 than they will spend on groceries, clothing, and shelter combined.

2010 IRS Data Book

The IRS recently released its 2010 Data Book. The Data Book is an annual summary of IRS activities for the fiscal year. The recent report describes activities conducted by the IRS from October 1, 2009, to September 30, 2010. It includes information on returns filed, tax collections, enforcement, and taxpayer assistance, as well as the IRS budget and workforce.

During fiscal year 2010, the IRS collected $2.3 trillion in revenue and processed 230 million returns. More than 119 million individual income tax return filers received tax refunds totaling $358 billion.

Assisting Grandchildren with College Costs

Contributing to a Section 529 college savings program is a great way for grandparents to help their grandchildren pay for college. It is also a great way to remove assets from the grandparent's estate without paying estate tax. As an added feature, money in a 529 plan owned by a grandparent is not assessed by the federal financial aid formula when qualifying for student aid.


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Grandparents, as well as other taxpayers, have a unique opportunity for gifting to Section 529 college savings plans by contributing up to $65,000 at one time, which currently represents five years of gifts at $13,000 per year. ($13,000 is the annual gift tax exclusion amount for 2011.) A married couple who elects gift-splitting can contribute up to double that amount ($130,000 in 2011) to a beneficiary's 529 Plan account(s) with no adverse federal gift tax consequences.

Example: Electing to spread a 529 Plan gift over five years.

In 2011, Linda contributes $75,000 to a 529 Plan account for the benefit of her grandson, James. She makes no other gifts to James in 2011. Because the gift exceeds the $13,000 annual gift tax exclusion, Linda elects to account for the gift ratably over five years beginning with 2011. Only $65,000 (five times the current annual gift tax exclusion) is eligible for the election; therefore, Linda is treated as having made an excludible gift of $13,000 in years 2011–2015, and a taxable gift of the remainder ($10,000) in 2011.

See the related article on page four for more information on nontaxable gifts, and contact us if you have questions concerning tax-effective college planning.

Deducting Interest on Home Loans

The political debate on tax reform touches many topics, including the federal tax deduction for interest on home loans. There is no way to determine if this deduction will continue or at what level, but we thought it would be a good time to review current federal law on deducting residential interest.

Interest paid on qualified residence debt is deductible, but limitations apply. Qualified residence debt can be either (a) home acquisition indebtedness, or (b) home equity indebtedness. Qualified residence interest expense incurred on up to $1 million ($500,000 for married filing separately) of home acquisition indebtedness is fully deductible for regular tax purposes as an itemized deduction. Taxpayers generally can deduct interest on up to $100,000 ($50,000 for married filing separately) of home equity indebtedness. However, there are restrictions on the deductibility of qualified residence and home equity interest for AMT purposes.

Mortgage interest is only deductible when paid by the taxpayer who is the legal or equitable owner of the property. Thus, a taxpayer cannot deduct interest he or she pays on the mortgage of another person. This may occur, for example, if parents make mortgage payments for their adult children. Similarly, a taxpayer who holds a mortgage generally cannot deduct the interest if it is paid by another person.

A qualified residence (for determining if the underlying debt is qualified residence debt) can be the taxpayer's principal residence and one other residence selected by the taxpayer for the tax year. In other words, if the taxpayer has several vacation homes in addition to a principal residence, the taxpayer can designate a different vacation home as the second qualified residence for different tax years. A residence is defined as (a) a house, (b) a condominium, (c) a mobile home, (d) a boat, (e) a house trailer, or (f) other property that under all the facts and circumstances can be considered a residence. Vacant land used for occasional camping does not qualify as a residence.

Planning Tip: Taxpayers with more than two homes should consider keeping a mortgage on their principal residence and one other residence selected as a qualified residence and paying off debt on any house(s) for which interest will not be deductible.

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Spouses who file a joint return may treat their common principal residence, as well as property that otherwise qualifies as a second residence, whether it is owned jointly or by one spouse only, as a qualified residence. Conversely, spouses who file separate returns may each take into account only one residence as the qualified residence, regardless of how the properties are owned. However, a deduction for a second residence is available if both spouses consent in writing to one of them taking into account both the principal and the second residence.

A residence under construction can be treated as a qualified residence for up to 24 months, but only if the residence actually becomes a qualified residence when it is ready for occupancy. However, the land a home is constructed on does not qualify as a residence under the above rule until construction begins. Interest on debt to acquire a lot that is incurred before construction begins would be personal interest. However, that interest could be deductible if a home equity loan is used to acquire the lot.

Please contact us to discuss the tax treatment for interest on your home loan or any other tax compliance or planning issue.

Home Sales by Newlyweds

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each spouse would be permitted to exclude up to $250,000 of gain if they filed separate returns.

Home sale gain exclusion qualifications can be mystifying, so please contact us to discuss the technical and tax-saving aspects of excluding a home sale gain.

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When Are Gifts Taxable?

The new federal estate and gift tax provisions signed into law late last year have received considerable attention and may have created some confusion concerning the taxability of gifts. So, we thought it would be a good time to review some basic information on the annual gift tax exclusion.


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Most gifts are not subject to the gift tax. For example, there is usually no tax when you make a gift to your spouse or a charity. If you make a gift to someone else, the gift tax usually does not apply until the cumulative value of the gifts you give to that person during the year exceeds the annual gift tax exclusion. In 2011, the annual federal gift tax exclusion amount is $13,000. A federal gift tax return generally does not have to be filed unless you give someone, other than your spouse or a qualifying charity, money or property worth more than the annual gift tax exclusion.

If federal gift tax is due, it typically will be paid by the person making the gift. The person receiving the gift does not pay federal gift tax or federal income tax on the value of the gift received. However, the person making the gift will not be able to deduct the value of the gift on his or her federal tax return, other than gifts that are deductible charitable contributions.

Thus far, we have indicated that gifts (a) for not more than the annual exclusion during the calendar year, (b) made to your spouse, or (c) made to a qualifying charity, generally are not subject to the federal gift tax. In addition to these provisions, tuition or medical expenses you pay directly to an educational or medical institution for someone else are not subject to federal gift tax, either.

Caution: You cannot first give the money to an individual for the purpose of paying the end recipient. To avoid federal gift tax liability, the money must be paid *directly* to the institution.

Gift-splitting is a technique available to married persons wanting to individually make a non-taxable gift of up to $26,000 in a single year. For split gifts, the donor's spouse must elect to split the gift with him or her. The gift is considered to be made half by the donor and half by the spouse. When a taxpayer elects to split a gift, a federal gift tax return must be filed to show that the spouses agree to use gift-splitting, even if the split gift is less than the annual exclusion ($13,000 in 2011).

Application of and aspects concerning the gift tax, including the impact of the $5 million unified estate and gift tax exclusion (not covered in this article), can be daunting. So, please contact us to discuss the tax aspects of gifting or any other tax compliance or planning issue.

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