Kiplinger

THE KIPLINGER TAX LETTER

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THE KIPLINGER WASHINGTON EDITORS

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Dear Client:

The tax rules on home-mortgage refinancing. Now is a good time to review them, especially with interest rates likely to slip a bit more.

Deductions when refinancing differ from your original mortgage. Generally, your write-off for points will be smaller when you refinance. But savvy use of refinancing proceeds can lower your overall tax bill.

Points paid on a refinanced loan are deducted over the loan term, not all in year paid as with a purchase-money mortgage on your main home. If you pay $4,500 of points on a 30-year refinancing loan, you deduct $150 of points a year. You'll need to keep track of the deduction yourself... will not be listed on the 1098 form. Claim it on line 12 of Schedule A. Deduction is allowed even if the points were added to the refinanced loan.

Refinancing with the same lender won't taint write-off for points. IRS will ignore court decisions that can be read as denying the deduction.

If you are rehabbing your home in conjunction with refinancing, part of the points is fully deductible in year paid if paid out of pocket. Deductible portion equals the percentage of loan used for improvements. Rest of the total points paid is deducted ratably over term of the loan.

If you are refinancing for a second time, the remaining balance of the points from the previous refinancing becomes deductible in full. Break is easy to miss if you are not careful...is not shown on Form 1098. You may be able to claim a big deduction. In the $4,500 example we noted, $3,900 balance of points can be taken if you refinanced after four years.

Now turn to the deductibility of interest when you refinance.

If you pull out more than the old loan balance on your main home, the first $100,000 of the excess is treated as home-equity indebtedness. Interest on that $100,000 is fully deductible even if you use the money for a car or other personal items. If you borrowed from another source, interest on the loan wouldn't be deductible. Using some of that $100,000 to make the purchase enables you to squeeze out another tax deduction.

If loan balance increases by more than $100,000 when refinancing, interest on excess isn't automatically treated as home mortgage interest, except for any portion that's used to substantially improve the residence.

How the money is used determines if you can deduct the interest.

If excess is for business or investment, interest is deductible in most situations, provided you can prove that's how the funds were used. The IRS insists on a direct and timely connection between the borrowing and the use of funds for investing or your business. If investment use, deduction for investment interest cannot exceed your investment income.

There's no deduction if excess is used for a car, furniture, etc.

Nor to the extent the total debt on the home exceeds its value.

Knowing these rules will maximize the tax benefits of refinancing.

Pending bankruptcy reform is a mixed bag for retirement plans. Legislation to tighten up bankruptcy laws is now moving through Congress.

Plan loans wouldn't be waived if borrowers filed for bankruptcy... would have to keep current or suffer the consequences if they defaulted.

403(b) & 457 plans would be exempt from creditors...the same rule that's now in effect for tax-qualified plans such as pensions and 401(k)s.

A $1-million asset ceiling would be placed on IRAs and Roth IRAs. Creditors could tap these accounts to extent balances exceeded $1 million. The change would mainly affect debtors who roll large lump sums into IRAs.

Removing a spouse as a plan beneficiary isn't as easy as it seems. A pension plan participant and his wife separated but didn't go to court to get their agreement OK'd. In the interim, he substituted his sister for his wife as plan's beneficiary, but his spouse never gave her consent. He died before divorce was final. His wife and sister sought his pension.

Spouse's written consent is needed to drop her as a beneficiary, an Appeals Court says. Exceptions are allowed when spouse can't be found or when there's a court-approved legal separation. Neither applies here. The sister gets nothing (Equity-League Pension Trust v. Royce, 2nd Cir.).

A way around the penalty on overdue payroll taxes is vexing IRS. When an employer takes withheld taxes and pays off its other creditors, IRS can levy a 100% penalty against those responsible for diverting funds. Courts have long been strict on those responsible...usually uphold penalty against company brass who knew gov't wasn’t being paid while others were.

A treasurer beat the penalty despite knowing taxes weren't paid. An Appeals Court let him off the hook last year after he was able to show that he didn't sign checks or make payment decisions when IRS wasn't paid.

IRS strongly disagrees...points to other cases imposing liability when co-owners who can sign checks know payroll taxes are going unpaid. The Service will keep trying to get the Appeals Court to reverse its view.

Some small-business trusts get estimated-tax relief from the IRS. Trusts whose beneficiaries are solely individuals, estates and charities can elect to be shareholders of S corporations. A bunch of these trusts paid estimated taxes in ’00 using their tax ID numbers for S-firm income that’s taxed to beneficiaries. The Service will let them file Form 1041-T so that the estimated-tax payments can be allocated to the beneficiaries.

Filing your tax return by private delivery services is allowed... overnight services offered by Airborne, DHL, FedEx and UPS will qualify. Returns will be treated as timely filed if sent by the April 16 deadline.

Slip-ups in express delivery can even be excused without penalty. An estate disputed an IRS audit, and its attorney timely sent its petition to the Tax Court by FedEx. Although the airbill was properly addressed, lawyer checked the wrong box and package ended up arriving 10 days late. Because petition was sent before deadline and bore the correct address, Tax Court says it is timely filed (Est. of Cranor, TC Memo. 2001-27).

Country clubs can claim a larger tax credit for employee tips... a credit for FICA tax on tips over the amount deemed part of minimum wage.

Credit is available for ALL tips received by food service workers, the Revenue Service says, not just tips earned from non-member activities. The credit can be carried back if it exceeds club's income tax liability.

Clubs can file refund claims with the IRS for all open tax years.

Tax-free asset transfers pursuant to a divorce come at a price. After a divorce, a developer defaulted on a note he had given his ex-wife in their property settlement. To settle the debt, he gave her real estate that had greatly appreciated. She sold the property several months later. Transfer of the real estate to her was tax free...related to the divorce.

Recipient must use transferor's tax basis for property conveyed pursuant to a divorce settlement, an Appeals Court says (Young, 4th Cir.).

Rule saddles the ex with a large gain on the sale of the parcel that she received. In effect, her former husband shifted his gain to her. She would have been much better off taxwise had she taken cash instead.

A co-owner's tax bill isn't waived if sales proceeds were stolen. A couple jointly owned a rental property. As they were getting a divorce, the unit was sold. But the husband kept the sales proceeds for himself... didn't give his wife her half. She said she shouldn't have to report gain on the sale. The divorce court's final decree also said she owed no tax.

Wife owes tax on 50% of the gain, according to the Tax Court... she owned half the house. Doesn't matter that money was misappropriated. The divorce court's order absolving her of any tax liability on the sale is ignored for federal tax purposes (Zimmerman, TC Summ. Op. 2001-13).

Voting rights can be severed from stock donations without penalty. The owners of a closely held corporation agreed to cede the voting rights on their stock to an outsider to facilitate any future sale of the firm. Years later, a shareholder opted to give some of the stock to a charity.

Gift qualifies as a charitable contribution, IRS privately rules. The donation isn't treated as a non-deductible gift of a partial interest because voting rights were transferred separately for a business reason.

Leasing pleasure craft to your S firm won't save any taxes. An attorney rented his three boats to his wholly owned S corporation. The S company used the boats to entertain the lawyer's various clients.

The lease payments are not deductible by the corporation... fall under the tax law's ban on deductions for entertainment facilities.

And rents remain taxable to the lessor, an Appeals Court says... do not become tax free because deduction is nixed (Catalano, 9th Cir.).

Too much passive income is bad for S companies. A 35% tax applies when more than 25% of receipts come from interest, dividends, rents, etc. Firms also can lose S status if the 25% limit is exceeded for three years. Affects corporations having retained earnings when switching to S status.

Rental income isn't passive if significant services are provided to the tenants...trash removal, repairs of units, security and the like.

Rents derived from a partnership investment can qualify, IRS says in a private ruling, as long as partnership performs key tenant services. Rents will retain their character as non-passive income for the S company.

Insolvent taxpayers must report more income from discharged debts. Folks whose liabilities are greater than their assets do not have income from debts being forgiven until amount waived exceeds their insolvency.

Assets exempted from creditors by state law cannot be excluded when calculating if a taxpayer is insolvent, according to the Tax Court. Are counted as part of the debtor's total assets (Carlson, 116 TC No. 9).

Means that fewer people will qualify as insolvent for tax purposes and get the exclusion, such as residents of states that shield homesteads.

Employee-safety and length-of-service awards can be tax free. Employers can give merchandise costing $400 or less tax free to employees per year. The tax-free limit rises to $1,600 a year for awards presented under a written plan that does not discriminate in favor of high-paids.

But other types of recognition awards have stricter limits... employee rewards for accomplishments other than safety or time on the job.

Merchandise must be of nominal value to be tax free, the IRS says in a private ruling...must qualify as a "de minimis" fringe to avoid tax.

Award of an item worth $100 is too large for tax-free treatment, in IRS' view. Employee is taxed, and company must withhold payroll taxes.

Claimants of innocent-spouse relief can receive extra protection from IRS. When an innocent spouse asks for abatement of a tax liability, the other party (a spouse or former spouse) can contest the proceedings. Spouses who are worried about retribution have been hesitant to go to IRS.

Taxpayers who fear retaliation can inform IRS when seeking relief by writing "Potential Domestic Abuse Case" at the top of their 8857 forms. IRS will mail correspondence with the other party from a central location so innocent spouse's whereabouts cannot be traced. It will also refuse to reveal address, phone number or workplace of a spouse requesting aid.

A revamping of penalties on prohibited transactions is coming. Currently, the penalty imposed on improper usage of retirement plan assets is 15% of the amount involved...becomes 100% if transgression isn't fixed. The IRS says the large penalty actually discourages voluntary compliance because of the high cost to plans that discover mistakes have occurred.

IRS will set up a self-correction program with smaller penalties for plans that turn themselves in and remedy relatively minor infractions of the prohibited-transaction rules. The new arrangement will be similar to one that now permits plans to avoid disqualification for small errors.

President Bush's tax plan faces slow going in the coming months, even though the House Ways & Means Com. has already OK'd his rate cuts.

The Senate is the main stumbling block. Democrats have the votes to filibuster Senate passage of any tax measure that they disagree with.

Tax cuts will be folded into the overall budget bill. That way, cuts cannot be bottled up because budget bills are exempt from filibuster.

This procedure means a two-track process before tax cuts pass:

First, Congress must set the overall size of a tax-reduction bill. Agreement on that isn't likely to emerge until mid-April at the earliest.

Next, the tax committees must draft the specific tax provisions, following the budget bill's instructions on how large a cut is permitted. Once the House and Senate OK their measures, the differences between them will have to be ironed out by a special House-Senate conference committee.

As a result, a final agreement is still several months away, probably not until late summer. In the interim, we will be scrutinizing the proposals to help you with your planning for the coming tax cuts.

Yours very truly,

The Kiplinger Editors