tax& financial UPDATE

Volume 22, Number 1 Spring/Summer 2015

contents:

Using the Home Sale Gain Exclusion **for More than Just Your Home**

With careful planning, and provided the rules are followed, the tax code allows the home sale gain exclusion every two years.

Let's assume you own a home, perhaps a second (vacation) home, or maybe are even thinking about buying a fixer-upper and flipping it. With careful planning, it is possible to apply the full home sale exclusion to all three of the properties.

Here is how it works. The tax code allows you to exclude up to $250,000 ($500,000 for married couples) of gain from the sale of your primary residence if you have lived in it and owned it for two of the five years immediately preceding the sale and you have not previously taken a home sale exclusion within the two years immediately preceding the sale. In addition, there is no limit on the number of times you can use the exclusion, as long as the requirements are met.

It makes sense to start off by selling the home you currently live in because you probably already meet the two-out-of-five-years ownership and use tests. The next step, if you have a second home, would be to move into it and make it your primary residence. After you have lived there for two full years and it has been more than two years since the previous home was sold, you can sell the property and take the home sale exclusion again. If you are handy, and find the right property, the next possible step would be to purchase and occupy a fixer-upper while you make repairs and improvements in preparation for its eventual sale after the two-year ownership and occupancy rules have been met. When that time is up, you can sell the fixer-upper and take the third exclusion. This makes it possible for a married couple to exclude as much as $1,500,000 of home sale profit in just over four years if they follow the rules carefully and time the sales correctly.

If you own a rental property, and you occupy the rental for two years prior to its sale, you will be able to exclude a portion of the gain for that property as well. Because so many rental owners were occupying their rentals before selling them and taking a home sale exclusion, Congress enacted a law barring the exclusion of gain attributable to rental periods after 2008. Thus, the home sale exclusion can only be used to exclude gain attributable to periods before 2009 and periods after 2008 in which the home was used as a primary residence.

Example: *You purchased and began renting a residence on July 1, 2005. On July 1, 2013, you occupied the property as your primary residence; and, on August 1, 2015, you sell the property for a gain of $230,000. You had owned the property for a total of 121 months, of which 67 were before 2009 or during which you occupied the property as your primary residence after 2008. Thus .5537 (67/121) of the gain is subject to the exclusion. As a result, $127,351 (.5537 x $230,000) of the gain qualifies for the exclusion.*

In the preceding example, had the gain exceeded the exclusion limits, $250,000 for single taxpayers and $500,000 married taxpayers, the exclusion would have been capped at the exclusion limits.

There is one final issue to consider. If any of the residences were acquired though a tax-deferred (Sec 1031) exchange from another property, then the residence must be owned for a period of five years prior to its sale to qualify for the exclusion.

Have a Financial Interest in or Signature Authority over a Foreign Financial Account?

Better Read This!

Each U.S. person who has a financial interest in or signature or other authority over any foreign financial accounts (including bank, securities, or other types of financial accounts in a foreign country) must report that relationship to the U.S. government each calendar year if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year.

The government uses this reporting mechanism as a means of uncovering hidden foreign accounts and ensuring that investment income earned in foreign countries by U.S. taxpayers is included on their U.S. tax returns. The Treasury Department has placed a new emphasis on foreign accounts, and taxpayers with a financial connection to a foreign country should determine whether or not they have a reporting requirement.

Reporting is accomplished by electronically filing Form FinCEN 114 commonly referred to as FBAR, which is **due on or before June 30** of the succeeding year. No extensions are available for filing this form.

Penalties for failing to comply can be draconian. For non-willful violations, civil penalties up to $10,000 may be imposed. The penalty for willful violations is the greater of $100,000 or 50% of the account's balance at the time of the violation. A reasonable cause exception to the penalty is available for non-willful violations but not for willful violations.

Overlooked Accounts – Many taxpayers overlook the fact that they have a reporting requirement in such situations as:

- **Family Accounts –** Recent immigrants to the U.S. may still have parents or other family members residing in the "old" country, and those relatives may have included them on an account in a foreign country. This practice is common for some ethnic groups. The taxpayer may not really consider the account to be his or hers; nevertheless, it falls under the reporting requirement if he or she has signature or other authority over the account and its value exceeds $10,000.
- **Inherited Accounts –** Accounts in a foreign country and inherited accounts fall under the FBAR reporting requirement, even if the funds are subsequently transferred to the U.S. The FBAR rules state that reporting is required if at any time during the year the foreign account exceeds $10,000.
- **Business Accounts –** A corporate officer or Board member may have signature authority over a business account in a foreign country and may overlook the need to meet the FBAR reporting requirements.
- **Foreign Financial Accounts –** These financial accounts are maintained by foreign financial institutions and include other investment assets not held in accounts maintained by financial institutions. However, no reporting is required for interests that are held in a custodial account with a U.S. financial institution.

In addition to including any reportable foreign income on a tax return, the taxpayer must ensure that the foreign account questions are completed correctly on the tax return and that the FBAR form is filed, if required.

Tax Tips for Recently Married Taxpayers

This is the time of year for many couples to tie the knot. If you marry during 2015, here are some post-marriage tips to help you avoid stress at tax time.

1. **Notify the Social Security Administration –** Report any name change to the Social Security Administration so that your name and SSN will match when filing your next tax return. Informing the SSA of a name change is quite simple. File a Form SS-5, Application for a Social Security Card at your local SSA office. The form is available on SSA's Web site, by calling 800-772-1213, or at local offices. Your income tax refund may be delayed if it is discovered your name and SSN don't match at the time your return is filed.

2. **Notify the IRS –** If you have a new address, you should notify the IRS by sending Form 8822, Change of Address.

3. **Notify the U.S. Postal Service –** You should also notify the U.S. Postal Service when you move so that any IRS or state tax agency correspondence can be forwarded.

4. **Review Your Withholding and Estimated Tax Payments –** If both you and your new spouse work, your combined income may place you in a higher tax bracket, and you may have an unpleasant surprise when we prepare your return for 2015. On the other hand, if only one of you works, filing jointly with your new spouse can provide a significant tax benefit, enabling you to reduce your withholding or estimated payments. In either case, it may be appropriate to review your withholding (W-4 status) and estimated tax payments, if any, for 2015 to make sure that you are not going to be under-withheld and that you don't set yourself up to receive bad news for the next filing season.

5. **Notify the Marketplace –** If you or your spouse has health insurance through a government Marketplace (Exchange), you must notify the Marketplace of your change in marital status. If you were included on a parent's health insurance policy through a Marketplace, then the parent must notify the Marketplace. Failure to notify the Marketplace can create tax filing problems.

If you have any questions about the impact of your new marital status on your taxes, please give this office a call.

Mid-Year Tax Planning **Checklist**

All too often, taxpayers wait until after the close of the tax year to worry about their taxes, missing opportunities that could reduce their tax liability or help them financially. Fall is the perfect time for tax planning. The following are some events that can affect your tax return; you may need to take steps to mitigate their impact and thus avoid unpleasant surprises after it is too late to address them.

- ☐ Did you get married, divorced, or become widowed?
- ☐ Did you change jobs or has your spouse started working?
- ☐ Did you have a substantial increase or decrease in income?
- ☐ Did you have a substantial gain from the sale of stocks or bonds?
- ☐ Did you buy or sell rental property?
- ☐ Did you start, acquire, or sell a business?
- ☐ Did you buy or sell a home?
- ☐ Did you retire this year?
- ☐ Are you on track to withdraw the required amount from your IRA (age 70.5 or older)?
- ☐ Did you refinance your home or take out a second home mortgage this year?
- ☐ Were you the beneficiary of an inheritance this year?
- ☐ Did you have a child? Time to start a tax-advantaged savings plan!
- ☐ Are you taking advantage of tax-advantaged retirement savings?
- ☐ Have you made any significant equipment purchases for your business?
- ☐ Are your cash and non-cash charitable contributions adequately documented?
- ☐ Are you keeping up with your estimated tax payments or do they need adjusting?
- ☐ Are you aware of and prepared for the 3.8% surtax on net investment income?
- ☐ Did you make any unplanned withdrawals from an IRA or pension plan?
- ☐ Have you updated your income and other information with your Health Marketplace?
- ☐ Have you stayed abreast of every new tax law change?

If you anticipate or have already encountered any of the above events, it may be appropriate to consult with this office, preferably before the event, and definitely before the end of the year.

Higher-Income Taxpayers Subject to Exemption & Itemized Deductions Phase-outs

Generally, taxpayers are allowed to deduct personal exemption allowances of $4,000 (2015) each for themselves, their spouses and their dependents. In addition, taxpayers are allowed a standard deduction or, if their deductions are large enough, itemized deductions.

However, both the personal exemption allowances and itemized deductions are being phased out for higher-income taxpayers. The phase-out begins when a taxpayer's adjusted gross income (AGI) reaches a phase-out threshold amount that is annually adjusted for inflation.

The phase-out threshold amounts for 2015 are based on taxpayers' filing statuses, and they are: $258,250 for single filers, $284,050 for individuals filing as heads of households, $309,900 for married couples filing jointly and $154,950 for married individuals filing separately. Here is how the phase-outs work:

Personal and Dependent Exemptions – The otherwise allowable exemption amounts are reduced by 2% for each $2,500 or part of $2,500 ($1,250 for a married taxpayer filing separately) that the taxpayer's AGI exceeds the threshold amount for the taxpayer's filing status.

Divorced or separated parents subject to the phase-out should consider relinquishing the exemption of a dependent child to the other parent. When a taxpayer is a party to a multiple support agreement, the taxpayer may want to allow another contributing member of the agreement who is not affected by the phase-out to claim the dependent's exemption.

Itemized Deductions – The total amount of itemized deductions is reduced by 3% of the amount by which the taxpayer's AGI exceeds the threshold amount. The reduction is not to exceed 80% of the otherwise allowable itemized deductions.

Not all itemized deductions are subject to the phase-out. The following deductions escape the phase-out:

- Medical and dental expenses
- Investment interest expenses
- Casualty and theft losses from personal-use property
- Casualty and theft losses from income-producing property
- Gambling losses

Thus, a taxpayer who is subject to the full phase-out still gets to deduct 20% of the deductions subject to the phase-out – and 100% of the deductions listed above.

Conventional thinking is to maximize deductions. However, taxpayers who normally are not subject to a phase-out may have a high-income year because of unusual income. In these cases, it may be appropriate, if possible, to defer paying deductible expenses to the year following the high-income year or perhaps to deduct the expenses in the preceding year. The standard deduction is not subject to the phase-out.

YOU ASKED: I was visiting with my sister recently and we ended up talking about each other's financial situation and taxes. It turns out that our yearly incomes are about the same, but the amount of taxes that we pay is entirely different. My income is from a pension and interest income; my sister's income is mostly dividends and gains from sales of stocks. We are both widows and collect about the same amount of Social Security benefits. Neither of us itemizes our deductions. My tax for 2014 was almost $6,000, while hers was just over $1,000. How can this be?

ANSWER: Your sister is no doubt benefiting from the capital gains tax rates. To the extent taxable income would otherwise be in the 15% or lower tax brackets, there is a zero percent capital gains tax rate on long-term capital gains and qualified dividends. And if taxable income falls above the 15% bracket, most long-term capital gains and qualifying dividends are generally taxed at no more than 15%. Your sister's taxable income consists mostly of the type of income that is eligible for these lower rates, with a large portion of that income apparently qualifying for the 0% tax rate. That explains why her tax is substantially less than yours. Fair? Perhaps not, but that's the law.

YOU ASKED: My uncle recently passed away and left me his substantial IRA account. The attorney handling the estate indicated the value of the IRA would be taxable to the estate and the withdrawals taxable to me. That seems like double taxation. Is that accurate?

ANSWER: Yes, the attorney is correct but failed to mention one very important factor. If you are the beneficiary of income that is taxable to you, you may be eligible for what is considered by many to be the most overlooked deduction in taxes. It is a deduction based on the additional taxes paid as a result of the same income being taxed to both the estate and to the beneficiaries of the estate. To the extent that the value of your uncle's IRA caused estate taxes to be paid, you are entitled to an estate tax deduction on your individual tax return. This may help mitigate the double taxation of the IRA.

tax& financial UPDATE

taxcalendar JUNE-SEPTEMBER 2015

June 15, 2015

– U.S. citizens living abroad on April 15, 2015 and who have a filing requirement must file a 2014 Income Tax Return (if not already filed) or file for an extension.

– Second installment of 2015 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

June 30, 2015

– Last day to report a financial interest in or signature or other authority over any foreign financial accounts with an aggregate value over $10,000 by filing FinCEN Report 114, more commonly referred to as FBAR. There are no extensions and substantial penalties for failing to file. Caution: the form must be electronically filed (a paper form cannot be filed) by the June 30 date.

June-July 2015

– Time to review 2015 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

July 31, 2015

– Due date for self-employed individuals and employers to file 5500 Series Returns for 2014 calendar year benefit plans (including Keogh/HR-10 plans).

September 15, 2015

– Third installment of 2015 Individual Estimated Taxes due.

– Due date for calendar year partnerships and corporations that were given a 5-month extension to file beyond the April 15 due date.

– This is also the due date for income tax returns (Form 1041) of calendar year estates and trusts that applied for the 5-month extension to file.