KAKENMASTER REPORT

A Newsletter from Kakenmaster & Associates and Libertyville Insurance Agency

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What Qualifies as a Home Mortgage Interest Deduction?

One of the long-time benefits of owning your own home has been deducting qualified home mortgage interest on your tax return. However, there may be limits as to how much interest is deductible.

The current tax laws allow taxpayers to deduct qualified mortgage interest as an itemized deduction for interest paid on up to $1 million of acquisition indebtedness plus up to $100,000 of home equity indebtedness. You can write off 100% of the interest you pay on up to $1.1 million of total debt secured by your first and second homes (combined) that was used to acquire or improve the properties. You can deduct home mortgage interest if you file Form 1040 and itemize deductions on Schedule A (Form 1040). The mortgage must be a secured debt on a qualified home in which you have an ownership interest.

There may be limits on how much mortgage interest is deductible

Secured Debt: Your mortgage is considered a secured debt if you put your home up as collateral to protect the interests of the lender. If you cannot pay the debt, your home can then serve as payment to the lender to satisfy the debt.

Qualified Residence: According to the IRS, a taxpayer's qualified residence is their primary residence plus one other residence which includes a house, condominium, cooperative, mobile home, house trailer, boat, or similar property that has sleeping, cooking, and toilet facilities. The IRS only allows one principal residence which is the home that is generally used the most throughout the year. The second home is any residence the taxpayer selects, and if it is not held out for rent or resale to others at any time during the year, you can treat it as a qualified home. According to the IRS, if you have a second home and rent it out part of the year, you also must use it as a home during the year for it to be a qualified home. In order to qualify as a second home, it must be used more than 14 days or more than 10% of the number of days during the year that the home is rented at a fair rental, whichever is longer. If you do not use the home long enough, it is considered rental property and not a second home.

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Thank You

Dear Clients:

Kakenmaster and Associates would like to thank you for choosing us as your tax preparer. We value the trust and confidence that you have placed in us and appreciate your business.

This issue of the *Kakenmaster Report* discusses, in detail, the home mortgage interest deduction and the various stipulations associated with this common deduction. In addition, this issue highlights just a few of the 55 tax provisions that expired at the end of last year. We will also look at the effect limited partnerships may have on your tax return.

As a year-round tax service, we are available to answer any questions regarding the issues covered in this newsletter, as well as other tax questions that may arise throughout the year. Please feel free to contact us if you have any questions.

Again, thank you for choosing Kakenmaster and Associates.

Sincerely,
Peter Kakenmaster

To all our **Abbott/Abbvie** clients: you will need to know your cost basis in your Abbvie stock for preparing your 2014 taxes due to the inversion.

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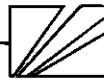

Mortgage Interest Deduction cont'd...

Interest from Home Acquisition Indebtedness: The amount of your home mortgage interest deduction depends on the date of the mortgage, the amount of the mortgage, and how you use the mortgage proceeds. If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages.

1. Mortgages you took out on or before October 13, 1987 (called grandfathered debt).

2. Mortgages you took out after October 13, 1987, to buy, build, or improve* your home (called home acquisition debt), but only if throughout 2014 these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately).

3. Mortgages you took out after October 13, 1987, other than to buy, build, or improve your home (called home equity debt), but only if throughout 2014 these mortgages totaled $100,000 or less ($50,000 or less if married filing separately) and totaled no more than the fair market value of your home reduced by the grandfathered debt or mortgages taken out after October 13, 1987. The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

Refinanced Home Acquisition Debt: Any secured debt you use to refinance home acquisition debt is treated as home acquisition debt. However, the new debt will qualify as home acquisition debt only up to the amount of the balance of the old mortgage principal just before the refinancing. Any additional debt not used to buy, build, or substantially improve* a qualified home is not home acquisition debt, but may qualify as home equity debt, which is described below.

Home Equity Debt: If you took out a loan for reasons other than to buy, build, or substantially improve your home, it may qualify as home equity debt. In addition, debt you incurred to buy, build, or substantially improve your home, to the extent it is more than the home acquisition debt limit ($1,000,000) may qualify as home equity debt. Home equity debt is a mortgage you took out after October 13, 1987, that does not qualify as home acquisition debt or as grandfathered debt and is secured by your qualified home.

You may not deduct interest on more than $100,000 of home equity debt for your main home and secondary residence. Home equity debt means any loan whose purpose is not to acquire, to construct, or to substantially improve a qualified home, or any loan whose purposes was to substantially improve a qualified home but exceeds the home acquisition debt limit. The home equity debt limit is reduced to $50,000 if you are married filing separately. Your deduction for home equity interest may be reduced even below the $100,000 limit if your indebtedness exceeds the fair market value (FMV) of your home.

For example, you own one home that you bought in 2000 with a current FMV of $110,000, and the current balance on your original mortgage (home acquisition debt) is $95,000. Bank M offers you a home mortgage loan of 125% of the FMV of the home, less any outstanding mortgages or other liens. To consolidate some of your other debts, you take out a $42,500 home mortgage loan [(125% x $110,000) = $137,500 - $95,000 = $42,500] with Bank M. Your home equity debt is limited to $15,000 ($110,000 - $95,000 = $15,000).

If your debt is higher than the limit of 100,000, interest on amounts over the home equity debt limit (such as the interest on $27,500 [$42,500 - $15,000] in the preceding example) is generally treated as personal interest and is not deductible. But if the proceeds of the loan were used for investment, business, or other deductible purposes, the interest may be deductible.

Deductible Interest from a Home Equity Line of Credit: For example, you borrowed $300,000 in a home equity line of credit, and the amount you borrowed did not exceed the fair market value of your house. You used $150,000 to add a new family room to your house. You spent the remaining $150,000 to pay for college tuition. Half of the loan is treated as home acquisition debt (the amount used to substantially improve your home). The other half is treated as home equity debt (the amount not used to improve your home). You would be able to deduct interest only up to the $100,000 limit on the home equity debt portion of the loan. Assuming you paid $21,000 interest on the loan, the amounts you can deduct would break down like this:

$10,500 - Fully deductible home acquisition debt (half the loan)

$7,000 - Deductible home equity debt (two-thirds of the home equity portion of the loan)

$3,500 - Non-deductible home equity debt (the interest paid on the home equity debt exceeding $100,000)

Please feel free to call Kakenmaster & Associates at 847-367-0888 if you have any questions regarding qualified home mortgage interest.

*The IRS defines an improvement as a substantial improvement if it: adds to the value of your home, prolongs your home's useful life, or adapts your home to new uses. Repairs that maintain your home in good condition, such as repainting your home, are not substantial improvements.

2013 Expired Tax Provisions

As 2013 came to a close, 55 popular tax provisions expired, affecting both individuals and businesses. Most expect Congress to pass legislation later in the year to reinstate many of the expired provisions, making them retroactive to the beginning of 2014. Here are some of the items that expired at the end of last year.

Deduction for State and Local Sales Taxes: Taxpayers who pay state or local income tax were allowed to deduct that amount from their federal taxes if they itemized. Taxpayers in states that do not collect income tax, such as Florida or Texas, or retirees in Illinois with low state income taxes were allowed to deduct state sales tax if that amount was higher.

Forgiven Debt on a Primary Home: The exception to the tax code that treated forgiven debt as a taxable income also expired. This exemption allowed qualifying homeowners to exclude up to $2 million in forgiven debt for a private residence that was the result of a negotiated mortgage, short sale or foreclosure.

IRA Contributions to Charity: Taxpayers 70 1/2 years and older were allowed to transfer up to $100,000 from an IRA directly to charity without first reporting it as income. If eliminated, the 3.8% Medicare surtax may have implications on a taxpayer's net investment income, as well as hurt taxpayers that do not itemize.

Mortgage Insurance Premiums: The deduction for private mortgage insurance premiums has also expired.

Teacher Out-of-Pocket Deductions: Teachers were allowed to deduct their out-of-pocket expenses up to $250 in purchases for school and classroom-related supplies. The deduction was allowed even if the teacher did not itemize.

Energy Tax Credits: The energy tax credits from the purchase of energy-efficient products such as energy efficient home improvements for home heating and cooling systems, insulation, windows and doors have also expired.

Research & Development (R&D) Tax Credit: Designed to stimulate more domestic R&D and innovation, this credit allowed certain types of expenses to be considered as a write-off.

Expensing Business Assets: Small and mid-size business owners were allowed to immediately deduct an amount up to $500,000 of qualifying equipment, rather than having to depreciate the expenses. If this provision is not reinstated, the limit drops to $25,000.

IRS News and Updates

IRS Simplifies the Tax Exempt Status Process:
On July 1, 2014, the IRS announced a new and shorter application form to help small charities apply for 501(c)(3) tax-exempt status more easily with the Form 1023-EZ. This new form is now only a 3-page application, compared to the standard 26-page application Form 1023. According to the IRS, most small organizations including as many as 70 percent of all applicants, qualify to use the new streamlined form. Most organizations with gross receipts of $50,000 or less and assets of $250,000 or less are eligible.

Bitcoins:
A bitcoin is both a digital (virtual) currency and a payment system. According to the IRS, bitcoins are treated as property for tax purposes. Those who sell or exchange bitcoins will realize a gain or a loss on the transaction. If the bitcoins are held for investments similar to stocks and bonds, the profit or loss from this type of investment will be considered a capital gain or loss.

Real Estate Rentals:
In order to qualify as a real estate professional, one must materially participate and perform more than 750 hours of services during the tax year in real property trades or businesses. For purposes of determining whether a taxpayer is a real estate professional, the taxpayer's material participation is determined separately for each rental property, unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity. You can elect to group your activities together by attaching a statement to the 1040 indicating that you treat all rentals as a single activity under section 469(c)(7)(A) of the tax code.

Grandkids & Summer Jobs

If your grandchild has a part-time or summer job, you can contribute up to $5,500 to a Roth IRA, but no more than the child earns. This gift can grow into a nice nest egg too. For example, if your grandchild earns $3,800 this summer, it will become nearly $27,000 after 40 years if the account earns just 5% annually. This contribution can also count toward the $14,000 annual gift tax exclusion ($28,000 for married couples). The Roth IRA also allows the child to withdraw up to $10,000 of earnings for the purchase of a first home, tax free.

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Financial, Insurance, and Real Estate Services for Businesses and Individuals

Contractor or Employee?

The IRS has a 20-factor test to classify workers as independent contractors or employees. This test helps determine if there are unpaid income tax and FICA payments, as well as unpaid FUTA by the employer.

The 20-factor test can be grouped into three categories. The first is the behavioral control test which determines if the employer has a right to direct or control how the worker performs the specific task for which he or she is engaged. The second test is the financial test, which examines who controls the economics of the worker's job. The last category involves the relationship of the parties, which illustrates how the parties perceive their relationship from a business perspective.

According to the IRS, "The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done."

Limited Partnerships

As the energy industry expands, more people are investing in limited partnerships (LPs). This type of investment often generates partnership income forms (K-1), which creates another level of complexity to your tax return. In addition, these forms often arrive late and create the need to file an extension. These complexities increase both the time it takes to complete the return and the preparation cost. Many additional forms and schedules could be required, including Schedule E (page 2) for income or loss from partnerships; Form 4794: Sale of Business Property; Schedule D (capital gains and losses); Form 4952: Investment Interest Expense; Form 6251: Alternative Minimum Tax; Form 8582: Worksheet for Publicly Traded Partnerships; and multiple state forms. Please note that because LPs increase the complexity of a tax return, additional charges of $50 - $100 per limited partnership is often required to complete returns with LPs. Please feel free to call Kakenmaster and Associates if you have currently invested in LPs and have questions regarding how it may affect your yearly tax return.

Thank You!

We would like to say thank you once again for trusting us as your tax preparer. We would also like the opportunity to serve your friends and family. This referral coupon is good for $30.00 off tax consultation services to any new tax clients. As a thank you for your referral, we will also send you a $30.00 thank you check. Thank you for choosing and recommending Kakenmaster and Associates to your family and friends.

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