July 2021

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Tax Newsletter

Max Out Mortgage Interest Deductions
How to cope with revised rules

Housing prices have been skyrocketing in many parts of the country. If you buy a home, at least you may qualify for generous mortgage interest deductions, as can many existing homeowners. Despite revised rules imposed by the Tax Cuts and Jobs Act (TCJA) for 2018 through 2025, you can generally continue to write off most, if not all, of the mortgage interest you pay during the year if you are an itemizer.

Background: Prior to the TCA, you could deduct interest as either acquisition debt or home equity debt, or both, within generous limits.

- **Acquisition debt:** This is debt where the mortgage proceeds are used to buy, build or substantially improve the home. Typically, acquisition debt represents the main part of a mortgage interest deduction. To qualify for the write-off, the loan must be secured by a qualified residence (e.g., your principal residence or a second home). The interest was deductible on loans up to $1 million.

- **Home equity debt:** When it was permitted by state law, you could deduct the interest on home equity loans secured by a qualified residence, regardless of how the proceeds were used. Deductions were limited to interest paid on the first $100,000 of debt. Plus, the loan amount could not exceed your equity in the home.

However, mortgage interest deductions were subject to the "Pease Rule," along with certain other itemized deductions. This rule reduced deductions for certain high-income taxpayers.

Latest rules: Beginning in 2018, the TCJA includes three key changes for homeowners.

1. The threshold for deducting interest paid on acquisition debt is lowered from $1 million to $750,000 for loans originating after December 15, 2017 (or April 1, 2018 if there was a binding contract in place before December 16, 2017).

In other words, existing homeowners are "grandfathered in" under the prior rules for acquisition debt. If you qualify, you can continue to deduct mortgage interest up to the $1 million threshold. Alternatively, you can still benefit under the $750,000 threshold.

2. The deduction for interest paid on home equity debt is suspended from 2018 through 2025. It does not matter when you acquired the residence. Currently, the deduction is scheduled to return in 2026.

3. In conjunction with other TCJA changes for itemized deductions, the Pease rule is suspended for 2018 through 2025. It is also scheduled to return in 2026, absent further legislation.

Overall, the TCJA changes do not affect many homeowners, while others are affected only slightly. Furthermore, you might be able to take advantage of a—

Special tax break: If you incur a new home equity loan or line of credit and use the proceeds for significant home improvements, the debt may be treated as an acquisition debt rather than a home equity debt. Reason: The debt is being incurred to "substantially improve" a qualified residence. Thus, you can add this mortgage interest to your deductible total if you itemize deductions.

Final words: Maximize mortgage interest deductions available under the prevailing tax rules. When warranted, contact your professional tax advisor for guidance.

Getting A Head Start On Business Deductions
Special tax rules for start-up costs

If you are starting up a new business venture as the pandemic abates, or buying an existing business, you may have to answer this question: When is the operation officially opening for business? This may be significant from a tax perspective.

Reason: While "ordinary and necessary" business expenses are generally deductible, start-up expenses must be capitalized. Thus, the business owner receives no tax benefit from those expenses until the business is sold, if ever.

Fortunately, however, the owner of a new business may write off certain "start-up costs" over a period of 60 months or more, beginning with the month in which the business begins. Therefore, the owner is able to derive some tax benefit from these expenses in the early years of ownership. It certainly behooves an owner to be "open for business" as soon as possible.

To qualify for the 60-month amortization, the start-up costs must be (1) those types of expenses that would normally be deductible as business expenses and (2) paid or incurred before the actual start of the business. This includes the following:

- Studies of potential markets, products, labor supply, transportation facilities, etc.;
- Advertisements for the business opening;
- Salaries and wages for employee training;
- Travel and other necessary costs for securing prospective distributors, suppliers or customers; and
- Salaries and fees for executives and consultants or for similar types of professional services.

Of course, the exact date a business is truly open depends on the nature of the business, but this typically means that you have started offering goods or services in exchange for payment. In other words, putting an "open for business" sign on a store's door, by itself, does not suffice.

Other key points: If the business exceeds the $5,000 limit for start-up costs, the excess must be amortized over 180 months. Furthermore, the $5,000 write-off is phased out on a dollar-for-dollar basis for costs above $50,000. Therefore, if start-up costs for the year exceed $55,000, your write-off is zero.

What happens if the attempt to start a new business fails? The qualified start-up expenses are characterized as capital expenditures and are deductible in the year of the business failure. Similarly, those expenses are deductible if the business is sold before the end of the amortization period. If all the technicalities under the law are satisfied, the business owner may qualify for a loss.

Final point: There are numerous complications to starting a new business. By assembling an experienced business advisory team, an aspiring entrepreneur can overcome the tax and legal hurdles. Do not hesitate to ask for assistance.

Gearing Up for an Auto-Enrollment Plan
Benefits for employees and employers

Recent legislative proposals would require 401(k) plans to automatically enroll employees in 401(k) plans as soon as they become eligible, while employers would qualify for tax credits. If enacted, these changes would boost retirement saving. But an automatic enrollment feature may already be added to a 401(k) plan.

Background: A 401(k) plan can be a "win-win situation" for employees and employers. Just take a quick look.

- For employees: You can defer up to $19,500 of salary to your account in 2021 ($26,000 if you are age 50 or over) in addition to receiving "matching" employer contributions. Contributions may grow without any tax erosion until they are withdrawn.

- For employers: A 401(k) plan may be a cost-efficient alternative to traditional pension or profit-sharing plans. It can also be an effective way to attract and retain valuable employees.

However, 401(k) plans are subject to strict nondiscrimination testing rules under the tax law. If your company's plan does not measure up, certain highly compensated employees (HCEs) might be penalized. This may occur if your company does not have a sufficient number of non-HCEs participating in the plan.

Fortunately, a relatively simple solution is available. Your company can use an automatic enrollment feature designed to encourage a higher level of participation among non-HCEs.

How it works: Usually, an employee must proactively elect to participate in a 401(k) plan. An automatic-enrollment plan takes a different approach. If employees do not make any election, they are considered to be participants. In other words, you have to choose to opt-out of the plan—not the other way around.

With an auto-enrollment plan, it is likely that a higher percentage of non-HCEs will participate than they would with a traditional plan. Under a safe harbor rule, your company can provide minimum contributions on behalf of these employees equal to 3% of compensation.

This change may be sufficient to satisfy the nondiscrimination tests for HCEs. Also, non-HCEs who are currently reluctant or passive about enrolling in a 401(k) plan may benefit in the future. This "forced savings" can help these employees build a retirement nest egg.

A plan provider, third-party administrator or consultant can help with the changes needed to install this feature. For example, participation may become automatic after one year of service. Typically, the plan will provide low-risk default investments divided among diversified mutual funds. Of course, employees are free to make other investment choices.

But the auto-enrollment feature is not without any potential drawbacks. For instance, the company may set a relatively low default rate to encourage contributions. If you do nothing, you might ride along with that rate for years while you could, and probably should, be saving more for retirement. Similarly, if you simply accept the investment choices established as the default, you may not be optimizing your earnings.

With professional assistance, you can make informed decisions taking your personal circumstances into account, whether or not your 401(k) plan uses an automatic enrollment feature. Do not hesitate to seek guidance.

How Long Should You Keep Tax Records?

Now that your 2020 return is safely tucked away, you may be wondering how long you need to hold onto your tax records. The standard answer is a minimum of three years, but maybe longer, especially if you are risk-averse.

Reason: The usual statute of limitations is three years. Therefore, the IRS has three years to review the situation and assess any tax deficiencies. But the three-year period is extended to six years if gross income is understated by more than 25%. And, if tax fraud is involved, returns may be challenged at any time.

Facts and Figures
Timely points of particular interest

Estate Tax “Thriller”—A new case involves the estate tax valuation of the name and likeness of the King of Pop. According to the Tax Court, the value is significantly less than the claims of IRS experts. Initially, the IRS argued the value should have been $434 million, but then reduced its estimate to $161 million. Michael Jackson’s estate argued that the value was only $3 million. Eventually, the Tax Court settled on $4.15 million.

Unemployment Benefits—The IRS continues to roll out its program this summer refunding the tax on unemployment benefits paid by taxpayers in 2020. Under the American Rescue Plan Act (ARPA), up to $10,200 of benefits received in 2020 is excluded from tax for someone with a modified adjusted gross income (MAGI) of up to $150,000. If this applies to you, check online to see the status of your refund.