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Tax Newsletter

Dividing up Interest Expenses
When you can claim deductions

Interest rates have gone up over the last few years. Saving grace: You may be able to deduct interest expenses depending on the type of expense incurred. Notably, there are four main categories for tax purposes.

1. **Mortgage interest:** Generally, you can deduct mortgage interest paid during the year. To qualify, you must be legally obligated to pay the mortgage and the loan must be secured by a qualified residence (i.e., your principal residence or one other home). Then you have to determine if the debt is an acquisition debt or a home equity debt.

- **Acquisition debt:** This is a debt incurred to buy, build or substantially improve a qualified home. Under the Tax Cuts and Jobs Act (TCJA), only the interest paid on up to the first $750,000 million of acquisition debt is deductible, down from $1 million. (However, certain prior debts are “grandfathered” so the higher limit may still apply.)

- **Home equity debt:** Other debts (e.g., a home equity loan or line of credit) are generally treated as home equity debt. Previously, the interest paid on up to $100,000 of home equity debt was deductible, but the TCJA suspends this write-off for 2018 through 2025.

Note that a home equity debt may be converted into an acquisition debt if the loan proceeds are used for substantial home improvements like adding an in-ground pool or finishing a basement.

2. **Investment interest:** If you borrow funds to buy property held for investment purposes (e.g., securities or real estate), the interest paid on the loan is treated as investment interest. The amount of investment interest you can deduct is generally limited to the amount of your “net investment income” for the year. Any excess is carried over to the next year.

Net investment income includes gross income from property held for investment such as interest, annuities and royalties. But it does not include capital gains and qualified dividends eligible for tax-favored treatment. The maximum tax rate for long-term capital gain and qualified dividends is generally 15% (20% for some high-income taxpayers) in contrast to ordinary income taxed at rates up to 37%. Note: You can elect to include long-term capital gain and qualified dividends as net investment income if you are willing to forfeit the preferential tax rate.

3. **Business interest:** The interest incurred by your business may be fully deductible. However, under the TCJA, the annual deduction for business interest is currently capped at 30% of adjusted taxable income (ATI). Key exception: A small business with average gross receipts of $25 million or less for the past three years (indexed to $29 million in 2023) is exempt from the limit.

4. **Personal interest:** If an interest expense does not fall into one of the other three categories, it is generally treated as nondeductible personal interest. This includes most credit card debt. **Key exception:** You may be able to deduct student loan interest paid for qualified higher education expenses— like tuition, room and board and books and fees—if the loan is in your name. This maximum deduction of $2,500 is phased out for high-income taxpayers.

This is only a brief summary of a complex set of rules. Obtain professional advice for your situation.

New Options for Emergency Expenses
Two tax provisions for 401(k)s

Do you have a 401(k) plan at work? This is a tax-favored way for employees to save for retirement. Unfortunately however, you may have to tap into your plan early due to extenuating circumstances. At least in some cases you may be able to avoid the tax penalty on early withdrawals.

Now the new legislation called SECURE 2.0 gives employees even more bandwidth. It includes two key provisions providing tax relief for emergency situations.

How it all works: Employees participating in a 401(k) plan can elect to defer part of their salary to their accounts on a pre-tax basis, subject to annual limits. For 2023, the limit is $22,500. If you are age 50 or older, you can make an additional “catch-up contribution” of $7,500, for a total of $30,000. (SECURE 2.0 further enhances the catch-up contributions for workers aged 60 through 63, beginning in 2025.)

An employer can also make “matching contributions” on behalf of employees up to a stated percentage of their compensation. All these amounts compound without any current tax erosion until withdrawals are made—usually, in retirement. These distributions are taxed at ordinary income rates currently topping out at 37%.

Caution: If an employee makes a withdrawal prior to age 59½, they are also liable for a 10% tax penalty, unless a special tax code exception applies. For instance, no penalty is assessed for distributions of substantially equal periodic payments (SEPPs) made over at least five years or until the employee turns age 59½, whichever comes later.

SECURE 2.0 includes the following two provisions intended to benefit 401(k) participants with emergency expenses:

1. **Emergency savings accounts:** Beginning in 2024, employers may allow plan participants to use a separate emergency savings account (ESA). This “sidecar account” is capped at $2,500 annually. Employees may be automatically enrolled at up to 3% of their compensation, up to the $2,500 cap, although plan participants can choose to opt out.

Participants must be allowed to take at least one withdrawal per month. (The first four withdrawals per year are not subject to fees.) Otherwise, the funds may be invested in a variety of approved methods.

Contributions to these ESAs must be eligible for the same matching contributions that apply to elective 401(k) deferrals. However, any matching contributions are made to the regular plan—not the ESA.

2. **Unforeseen financial needs:** Another SECURE 2.0 provision allows a participant to make a penalty-free withdrawal from their retirement account of up to $1,000 per year to pay for “unforeseeable or immediate financial needs relating to personal or family emergency expenses.” An employer may rely on an employee’s written certification that they are facing a qualified expense. But there is a catch: A withdrawal made for this purpose must be repaid within three years.

If you do not repay the distribution in a timely fashion, you are prohibited from making any further withdrawals until repayment is made. This provision also takes effect in 2024.

Bottom line: Weigh all the tax and financial ramifications before making any withdrawals from your 401(k). Seek guidance from your professional advisors.

Favorable Results With a Crummey Trust
Benefits of unique estate planning technique

Despite its derogatory-sounding name, a "Crummey trust" can provide a favorable outcome for individuals looking to transfer a significant amount of assets to the younger generation. This device might be incorporated into a comprehensive estate plan.

Background: One time-tested way of saving estate tax is to utilize the annual gift tax exclusion during your lifetime. Currently, this provision enables you to give away up to $17,000 each year to each recipient without paying any federal gift tax ($34,000 for a joint gift by a married couple). For example, if you have two adult children and three grandchildren, you and your spouse can give each one $34,000 for a grand total of $170,000 in tax-free gifts.

This is a relatively simple way to reduce your taxable estate. Gifts in amounts above the annual exclusion may be sheltered from gift tax by the lifetime gift tax exemption of $12.92 million in 2023, but this reduces the effective estate tax shelter.

When you make an outright gift to a child, however, you give up control over the assets. In other words, you run the risk that the money may be squandered—especially if the child is young or financially irresponsible. Instead, if the assets are transferred to a trust with the child as a beneficiary, you can appoint a trustee to manage the property. After a specified period of time (e.g., when the child reaches a certain age), the assets are distributed to the child.

Potential problem: To qualify for the annual exclusion, the gift must be one of a "present interest." When a gift is placed in a trust and is not distributed to the beneficiary for a period of years, it is generally considered a "future interest." This triggers a taxable gift.

The Crummey trust was devised as a solution to this problem. (It is named for the landmark case that authorizes its use). Typically, the beneficiary of the trust is granted the right to withdraw trust principal shortly after it is transferred to the trust. Because the beneficiary has a present right of withdrawal, the gift qualifies for the gift tax exclusion.

Of course, if you are the donor of the trust, you may not want your child to withdraw the assets. Nevertheless, these so-called "Crummey powers" are usually not exercised. While the beneficiary must be notified of the withdrawal power, they may be too young to understand the implications. The trust principal does not have to be paid out when the beneficiary reaches a certain age, so the trust can continue for a long period of time.

Final words: Be aware that there are several variations on this theme. Typically, this is not a do-it-yourself proposition. Setting up and administering a Crummey trust usually requires expert assistance. Do not hesitate to seek professional guidance.

How Tax-Friendly Is Your State?

The amount of state taxes your business must pay can have a substantial impact on your bottom line. This includes income taxes and other tax liabilities.

To give you an idea of where you stand, the Tax Foundation provides an annual update of the "best" and "worst" states for **business taxes**. In the latest ranking, Wyoming, South Dakota and Alaska lead the pack, while California, New York and New Jersey bring up the rear.

For the complete list, refer to the State Business Tax Climate Index at taxfoundtaion.org/2023-state-business-tax-climate-index.

Facts and Figures
Timely points of particular interest

The Tax Burden—According to statistics recently released by the IRS, high-income taxpayers are shouldering more of the tax load. Based on data from the 2020 tax year, the top 1% of individuals paid 42.31% of income taxes, up from 38.77% in 2019. This group reported 22.19% of adjusted gross income (AGI). It took an AGI of at least $548,336 to crack the top 1%. In comparison, the bottom 50% of filers paid only 2.32% of the total federal income tax liability.

Unclaimed Refunds—In what has become an annual occurrence, the IRS has announced that almost 1.5 million individuals across the country have unclaimed refunds for the 2019 tax year. These taxpayers face a **July 17** deadline for submitting their tax returns in order to claim their refunds. The average median refund is $893 for this year. The IRS has completed a special state-by-state calculation to show how many people are potentially eligible for these refunds.

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