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Tax Newsletter

Four Big Back-to-School Tax Breaks
Learn tax ABCs for college students

Do you have a child attending college this fall? Whether the school has remote learning or classroom instruction—or a hybrid—you may be entitled to various tax breaks on the 2020 return you will file in 2021. Here are four of the tax benefits on the books.

1. American Opportunity Tax Credit: This credit, which has expired and been reinstated numerous times in the past, is now permanent. The maximum American Opportunity Tax Credit (AOTC) of $2,500 covers qualified expenses like tuition, room and board, fees, supplies and equipment.

Notably, the AOTC is available for each student in your family. For example, if you have two kids in school at the same time, you can claim a maximum credit of $5,000. Furthermore, the AOTC is available for up to four years of school for each child.

But the credit is phased out based on modified adjusted gross income (MAGI).
For 2020, the phaseout range is between $80,000 and $90,000 of MAGI for single filers and $160,000 and $180,000 for joint filers.

2. Lifetime Learning Credit: The Lifetime Learning Credit (LLC) is also a permanent part of the tax code. However, unlike the AOTC, the maximum credit for qualified expenses is $2,000, instead of $2,500. Also, the LLC applies on a per-taxpayer basis. Therefore, if you have two children in school in 2020, the maximum credit remains $2,000.

The LLC is phased out at lower levels than the AOTC. The phase-out range for 2020 is between $59,000 and $69,000 of MAGI for single filers and $118,000 and $138,000 for joint filers.

Caution: Generally, you can claim either the AOTC or the LLC, but not both. Based on the comparisons stated above, the AOTC is favored by most taxpayers.

3. Tuition-and-fees deduction: This deduction for tuition and related fees, which technically had expired, was restored through 2020. But it can only be claimed in lieu of either one of the two tax credits, the AOTC and the LLC.

This deduction of either $4,000 or $2,000 is claimed "above the line," depending on MAGI. For single filers, the $4,000 deduction is available for a MAGI up to $65,000 and $2,000 for a MAGI between $65,000 and $80,000. Joint filers can deduct $4,000 for a MAGI up to $130,000 and $2,000 if MAGI is between $130,000 and $160,000.

Currently, the deduction is scheduled to expire at the end of this year but it could be reinstated again.

4. Student loan interest deduction: Congress recently eased the rules for repaying student loans in 2020. If you still pay interest on a loan this year, however, you can deduct the payments up to a maximum of $2,500. This deduction is also claimed above the line.

Note that the deduction for student loan interest is also subject to a phase-out. For 2020, the phase-out range for single filers is between $70,000 and $85,000 of MAGI and between $140,000 and $170,000 of MAGI for joint filers.

Be aware that the deduction is only available to a taxpayer obligated to repay the loan. Thus, the student—not the parents—often claims it.

Final lesson: Consult with your tax advisor to maximize the current tax breaks for children in college.

Tax Rules for PALs: Not So Friendly
Maximize tax benefits of passive activities

Do you own investment real estate—perhaps an apartment building—you rent out to tenants? Despite complications this year, the real estate may still be a valuable source of income. Of course, any rental income you receive is taxable, but the resulting tax liability may be offset by deductible expenses. In some cases, you might even qualify for a loss—especially in 2020.

However, there is another wrinkle in the tax law. The loss may be disallowed under the "passive activity loss" (PAL) rules.

Background: Generally, losses from passive activities can only offset income earned from other passive activities. Any excess passive loss for the current year may be carried over indefinitely to future years.

For this purpose, a passive activity is an undertaking involving the conduct of a trade or business in which you do not **"materially participate."** This means participation in the business activity on a regular, continuous and substantial basis. The IRS has issued regulations detailing the requirements for attaining this status. For example, you are considered to be a material participant if you work more than 500 hours a year at the activity.

A rental real estate activity is treated as a passive activity whether or not you materially participate in it. However, under a special tax law provision, an **"active participant"** in rental real estate may be able to use up to $25,000 of loss to offset non-passive income. This exception is phased out for investors with an annual adjusted gross income (AGI) between $100,000 and $150,000. The tax benefit disappears completely if your AGI exceeds $150,000.

Note that the "active participation" test is less stringent than the "material participation" test. Still, the participation must be significant and legitimate. For instance, you might make management decisions, approve new tenants, arrange for repairs and so on. But simply listing yourself as a real estate manager or rental agent is not enough.

Add another complication to the tax equation. Under current law, a 3.8% tax applies to the lesser of **"net investment income"** (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds $200,000 for single filers and $250,000 for joint filers. The definition of NII covers many income items such as capital gains, dividends, interest and the like. Significantly, NII also includes income from a passive activity.

One possible way to avoid an adverse tax outcome is to increase your level of participation to qualify as a "real estate professional." Typically, to satisfy this test, you have to spend more than 750 hours on the activity during the year. Depending on your circumstances, it may be well worth the extra effort.

Alternatively, you might invest in passive income generators (PIGs) at the end of the year. By creating more passive income through a PIG, you can absorb a passive activity loss.

In summary: Analyze your personal situation with your tax advisors. Then develop a plan that takes all the economic and tax implications into account.

Five Ways to Insulate Your Estate
Protecting assets from creditors

Unfortunately, it is not enough to develop an estate plan that provides financial security for the future. A comprehensive plan also will protect your assets from aggressive creditors. If you have not made any provisions yet, take action as soon as possible.

What is the rush? You will not have much recourse if you wait until the day you are sued. In addition, your actions may be voided if you are insolvent or on the verge of bankruptcy. The time to act is before trouble actually begins.

Caution: State law generally controls in these situations. The best approach is to consult with an attorney familiar with the applicable laws. Keeping that in mind, here are five possible ways to insulate your estate.

1. You may make irrevocable gifts of property to your spouse, your children or your favorite charities. Make sure that the gifts have been properly documented so you have proof that a gift actually occurred.

2. When permitted under state law, you might consider establishing a "spendthrift trust." According to the terms of such a trust, any income earned from the trust property can be distributed to a designated beneficiary. Be sure that you choose a capable and experienced trustee to manage the assets.

3. You can also use cash to buy a single premium life insurance policy naming your spouse and/or children as beneficiaries. The same goal can be achieved by transferring the policy to an irrevocable life insurance trust. Again, this is prohibited in some states. Check to see what your alternatives are.

4. A grantor retained income trust (GRIT) is designed to keep property from creditors. In brief, income-producing property is transferred to a trust, while you retain an interest income for a stated time. Simultaneously, you give away an irrevocable interest of the remainder to a named beneficiary. Once the trust term expires, the beneficiary receives the property outright. A comparable alternative is a grantor retained annuity trust (GRAT). Caveat: GRITs and GRATs are complex arrangements with gift tax ramifications.

5. It may be possible to transfer assets to your spouse if you take steps to ensure that you have not retained any ownership rights in the property. For example, real estate property that is held in your name or jointly with your spouse can be legally conveyed by signing and recording a deed that gives your spouse total and complete ownership. Since you no longer own the property, creditors cannot reach it.

Note: The transfer may have other ramifications. For instance, this may not be a prudent move when a marriage is on shaky ground. In addition, a court could hold that the transaction is a sham. It is important to observe all the legal formalities in this area. Of course, depending on state law, your home, car and other items of personal property may be beyond the reach of creditors. The same goes for accumulated benefits in a qualified retirement plan.

Reminder: Transferring assets out of your estate does more than keep creditors at bay. It also removes the assets from your taxable estate. This may cut down any potential estate tax your family may owe in the future.

Plug In Electric Vehicle Credit

Are you in the market for an electric vehicle? You may qualify for a special tax break, but you might have to move fast.

The tax law authorizes a tax credit for **electric plug-in vehicles**. If certain requirements are met, you may claim a maximum credit of $7,500. But the credit begins to phase out for a manufacturer's vehicles when it has sold 200,000 qualifying vehicles for domestic use.

For instance, a credit is no longer available for the popular Tesla models. Check into this aspect before you finalize a deal.

Facts and Figures
Timely points of particular interest

Capital Loss Reminder—As we head into the last quarter of the year, investors should be reminded of the tax benefits available for capital losses. For instance, if you sell securities at a loss, the loss may be used to offset a high-taxed short-term capital gain and up to $3,000 of ordinary income in 2020. Any excess is carried over to 2021. Factor the tax consequences into year-end securities sales.