

TAXOLUTIONS



►► *ideas on taxes*

A VACATION HOME — ENJOY THE BENEFITS

If a mountain getaway or an ocean view has become your American dream, then perhaps you should know that a vacation home can offer some tax savings that may help pay for your hideaway. The tax laws differ depending on whether you use the home solely for enjoyment or mix business with pleasure by renting the property part-time.

As long as the combined debt secured by the vacation home and your principal residence does not exceed \$1 million, you can deduct all of the interest paid on a mortgage used to buy a second home. Furthermore, you may be able to deduct interest on up to \$100,000 of home equity loans. These advantages are restricted to two homes. If you purchase a third, interest on that mortgage is not deductible. However, no matter how many homes you have, you may be able to deduct all the property taxes you pay.

One break enjoyed by homeowners — the right to immediately deduct points paid on a mortgage — applies only to a principal residence. Points paid on a loan for a vacation home must be deducted gradually as you pay off the mortgage.

Personal Residence

Your vacation home counts as a personal residence even if you rent it for up to 14

days a year. In that case, you get to retain the rent tax free and don't jeopardize your mortgage interest and tax deductions. However, you may not deduct any rental-related expenses. If you rent the house on a continual basis, things may become complicated. Different rules apply depending on the breakdown between personal and rental use.

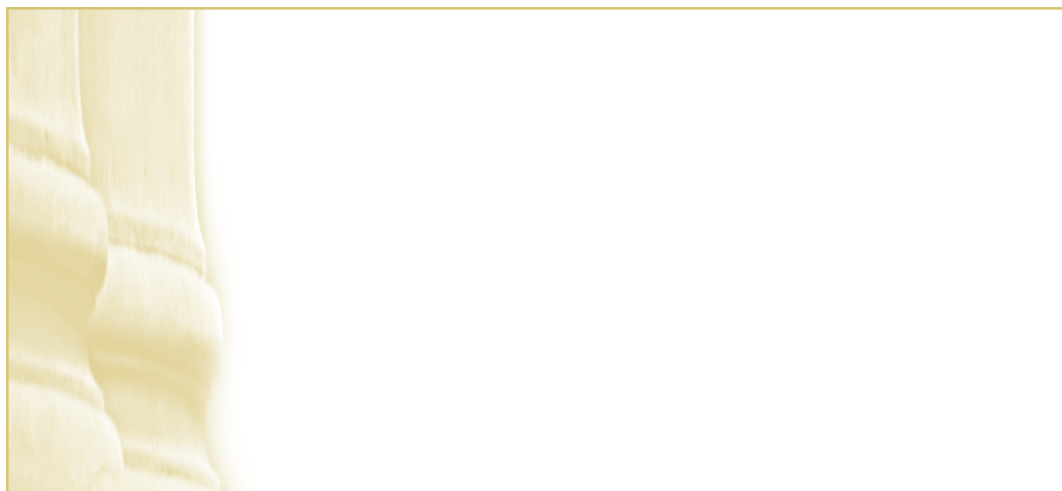
First, if you buy primarily for pleasure but rent for 15 days or more, the rent you receive is taxable. The house is still considered a personal residence if you spend more than 14 days or 10% of the rental days there (whichever is greater), so you get to deduct all the interest and property taxes. You may also be able to deduct other rental-related expenses including the cost of

utilities, repairs, and insurance attributable to the time the house is rented. In some cases, you might even get to deduct depreciation. When the house is considered a personal residence, rental deductions can't exceed the amount of rental income you report. In other words, your second home can't produce a tax loss to shelter other income. In most cases, the interest and taxes assigned to the rental use of the house, plus the operating expenses, more than offset rental income, limiting your ability to write off depreciation.

Rental Property

Now consider your tax situation if you buy a property primarily as an invest-

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KEEPING PACE WITH TUITION HIKES

Every year, college gets more expensive. According to the College Board, the average cost for the 2003–2004 academic year at a four-year private college was \$19,710, up 6% from last year. The increase for one year at a public school jumped 14.1% to an average of \$4,694.

If the price tag for a college education continues to increase 6% annually, in ten years the average cost for one year at a private school will be an estimated \$35,000. For young families, skyrocketing cost projections can lead to sticker shock, but there are strategies that can help you keep pace with tuition hikes. The College Board reports that almost 60% of undergraduate students receive financial aid and almost 50% receive grants. In addition, the federal government pitches in with tax breaks for 529 plans and Coverdell Education Savings Accounts (ESAs) and by offering tax credits and deductions.

529 Plans and ESAs

529 plans are qualified tuition programs (QTPs) that come in two forms: prepaid tuition plans and college savings plans. Prepaid tuition plans allow you to lock in today's tuition rates at certain state colleges and universities for a child's future education. With a college savings plan, you invest in a professionally managed account that offers a variety of investment options. Earnings grow on a tax-deferred basis, and withdrawals used for qualified education expenses (tuition, room, and board) are tax free. In addition, a special gift tax rule allows individuals to gift up to \$55,000 in one year free of transfer tax.

Prior to the popularity of 529 plans, many people saving for their children's education opted for either a Uniform Gifts to

Minors Act (UGMA) account or a Uniform Transfers to Minors Act (UTMA) account. It is possible to fund most 529 plans with assets from an UGMA or UTMA account; however, the rules governing the custodial account still apply. Investments to a 529 plan must be made in cash, so it may be necessary to sell UGMA/UTMA assets, such as stocks or mutual funds, and capital gains tax may be due. However, remember that future withdrawals from a 529 plan will not be



federally taxed if they are used for qualified expenses. In addition to college expenses, funds may also be used for graduate school.

Another savings option is the ESA. Formerly known as education IRAs, ESAs can be used to fund elementary and secondary educations, as well as college. As with the college savings plan, ESA earnings grow tax deferred, and qualified withdrawals are tax free. In 2004, the contribution limit is \$2,000.

Credits and Deductions

If you are currently paying higher education expenses, two federal tax credits may lessen your tax bill: the Hope Scholarship Credit and the Lifetime Learning Credit. For 2004, eligibility phases out for married

couples filing jointly with modified adjusted gross incomes (MAGIs) of \$85,000 (\$42,000 for single filers). The Hope Credit provides a \$1,500 tax credit for college education expenses during a student's first two years. The Lifetime Learning Credit, which applies not only to undergraduate study, but also to graduate and professional education pursuits, covers 20% of the first \$10,000 in expenses. If a student qualifies for both credits in the same year, you may claim either credit, but not both.

An above-the-line deduction applies to qualified higher education costs through 2005 for those whose income exceeds the Hope Scholarship and Lifetime Learning Credit limits. The deduction "sunset" after 2005 (unless Congress acts to extend it). The deduction is a dollar-for-dollar amount, up to a maximum. In 2004, the deduction is limited to \$4,000 for single filers with MAGIs below \$65,000 and joint filers with MAGIs below \$130,000. The maximum deduction is \$2,000 for single filers with MAGIs between \$65,000 and \$80,000, and for joint filers with MAGIs between \$130,000 and \$160,000.

A deduction is not available for taxpayers whose income exceeds the MAGI limits. Even one dollar of excess MAGI means that no deduction can be claimed. This deduction cannot be claimed for any student on whose behalf the Hope or Lifetime Learning Credit is being claimed for the year.

Student Loan Deductions

Student loan repayments may also offer tax savings. In 2004, up to \$2,500 of interest paid on student loans is tax deductible both for taxpayers who take the standard deduction and for those who itemize; however, certain income limits apply. Single taxpayers with

THE POWER OF LEGAL PROTECTION

Without the proper legal, financial, and health care protection, you may be at risk should you become incapable of directing your own affairs. Advance directives are important planning tools that can set forth your preferences in the event an accident or illness impairs your ability to make decisions. Let's look at three tools that can help you prepare for the future: a durable power of attorney, health care proxy, and living will.

Durable Power of Attorney

A durable power of attorney grants authority to another person to make legal and financial decisions on your behalf in the event of mental incapacity. The powers granted can range from broad to limited in scope. With a durable power of attorney, your designee can assist you with decisions regarding your financial and tax situation, investments, insurance transactions, government benefits, estate plans, retirement plans, and business interests.

In the absence of such legal protection, court intervention (with the accompanying time and expense) may be necessary. A durable power of attorney

is generally inexpensive and easy to implement.

Health Care Proxies

While a durable power of attorney grants authority to another person to make financial decisions, a health care proxy (also known as a medical durable power of attorney or a durable power of attorney for health care) appoints



someone to make health care decisions on your behalf. This directive only takes effect if you are unable to direct your own medical care, and you can generally change or revoke it at any time.

A health care proxy does not enable the designated person to make any financial, legal, or business decisions on your behalf, only medical decisions. In

addition to a health care proxy, it is also common to have a living will.

Living Wills

A living will generally allows you to state your preferences regarding the giving or withholding of life-sustaining medical treatment. In most states, you must have a terminal condition, be in a persistent vegetative state, or be permanently unconscious before life-support can be withdrawn. The definition of these terms and the medical conditions covered may vary from state to state.

It is important not to confuse a living will for a testamentary will, which provides for the disposition of property upon death. One is never a substitute for the other.

Federal law (the Patient Self Determination Act of 1991) requires hospitals to inform patients about advance directives. With health care proxies and living wills, you are able to guide your future medical care, even if you become unable to make informed decisions. To ensure that your legal and financial wishes are also met, legally appoint someone you trust with a durable power of attorney. ■

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KEEPING PACE WITH TUITION HIKES

MAGIs of \$50,000 or less (\$100,000 for married couples filing jointly) are eligible to deduct up to \$2,500 of interest paid on a student loan that covered qualified education expenses, such as tuition, room, and board. Single filers with MAGIs less than \$65,000, and joint filers with MAGIs less than \$130,000, qualify for partial deductions. Prior to tax year 2002, only in-

terest payments made within the first 60 months of loan repayment qualified for the deduction, but the IRS has eliminated this limitation.

In addition to tax breaks, the federal government also funds numerous aid programs. Some of the most popular and beneficial opportunities are: Pell Grants, Supplemental Education Opportunity

Grants (SEOGs), Perkins Loans, PLUS Loans (Parent Loans), Direct Stafford Loans, and federal work-study programs.

For many families, a combination of funding techniques works best. We can help you choose the right tax strategies for your situation. Remember, it's never too early to begin planning for your child's college education. ■

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ment and limit your personal use of the property to 14 days a year (or 10% of the number of rental days if that allows you more than 14). Because the house is a rental property in the eyes of the Internal Revenue Service (IRS), your deductions can exceed the amount of rental income you receive.

If your rental income does not cover the cost of renting the house, you may be able to claim a taxable loss. Rental losses are classified as passive and can be deducted only against passive income such as another rental property that realizes a gain. If you do not have



passive income to shelter, the losses have no immediate value (unused losses can be used in future years when you have passive income).

There's an exception to this rule, however, that permits taxpayers with adjusted gross income (AGI) under \$100,000 to deduct up to \$25,000 of passive losses against other kinds of income, including salaries. To qualify, you have to actively manage the property. The \$25,000 allowance is gradually phased out as AGI rises between \$100,000 and \$150,000.

When your vacation home is considered a rental property, the mortgage interest attributable to the time the premises are rented is a business deduction. The rest, though, can't be deducted as home mortgage interest since the house doesn't qualify as a personal residence.

The tax laws discussed here also apply to homes other than houses, such as apartments, condominiums, mobile homes, or boats with basic living accommodations. Generally, these include a sleeping space, bathroom, and cooking facilities. Hotels, motels, and inns are treated differently.

Are you enjoying all of the available tax benefits your vacation home may offer? Call us for more information and guidance. ■

Retirement Saving in 2004

The tax landscape is constantly changing, making it a challenge to keep up with the amount you can put into a retirement account. Certain dollar amounts are scheduled to change annually, while others are indexed for inflation. Let's take a look at what you can contribute in 2004.

You can put up to \$3,000 in an Individual Retirement Account (IRA) or a combination of IRAs, and earnings grow tax deferred. Contributions to a traditional IRA may be deductible depending on your income and participation in an employer-sponsored retirement plan. Those who are age 50 or older are allowed to make "catch-up" contributions of \$500. Qualified withdrawals from a traditional IRA will be subject to income tax, while qualified withdrawals from a Roth IRA are tax free.

Simplified Employee Pension plans (SEPs), 401(k), 403(b), and 457 plans allow participating employees to make pre-tax salary deferrals of up to \$13,000 in 2004. The contribution limit for these plans will climb \$1,000 each year, reaching \$15,000 in 2006. Earnings for



all plans grow tax deferred. These plans also permit catch-up contributions. Those age 50 and older may make additional contributions of \$3,000, and this amount is also scheduled to increase each year by \$1,000 through 2006.

Savings Incentive Match Plans for Employees (SIMPLEs) allow employees to make pre-tax contributions of up to \$9,000 in 2004, and earnings grow tax deferred. Catch-up contributions for participants age 50 and older are limited to \$1,500.

With fewer and fewer companies offering traditional pensions, taxpayers are more and more responsible for saving for retirement. We can help you coordinate your tax strategies with your financial goals.