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Tax Newsletter

Roundup of Five Top Tax Credits
Tax savings on personal returns

What would you rather have—a tax deduction or a tax credit? In most cases, the answer is the tax credit. Reason: A credit reduces tax liability on a dollar-for-dollar basis, while a deduction offsets income based on your tax bracket. For instance, a $1,000 deduction is worth $370 to someone in the top 37% bracket, but a $1,000 tax credit is worth $1,000.

Accordingly, following is a summary of five popular credits that may be claimed by individual taxpayers on 2024 returns.

1. Higher education credits: You may be able to take advantage of either one of two tax credits (but generally not both) for higher education expenses: The American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit (LLC).

- AOTC: The maximum credit of $2,500 per eligible student can be claimed in each of the first four years of college study. The credit begins to phase out for single filers with a modified adjusted gross income (MAGI) above $80,000 and joint filers above $160,000.

- LLC: The maximum credit of $2,000 per taxpayer can be claimed in any year of undergraduate, graduate or professional degree study. The credit begins to phase out at the same MAGI thresholds as the AOTC. Because of the higher maximum credit, the AOTC is usually preferable to the LLC.

2. Child Tax Credit: A $2,000 credit is available for every qualifying child under age 17 whom you claim as a dependent. However, the tax benefits of the Child Tax Credit (CTC) are phased out on 2024 returns for single filers with a MAGI above $200,000 for single filers and $400,000 for joint filers. The allowable credit is reduced by $50 for every $1,000 (or fraction thereof) above the threshold.

3. Dependent care credit: You may claim the dependent care credit—sometimes called the "child care credit"—for the cost of caring for a child under age 13 or another dependent incapable of self-care. To qualify, the expenses must be incurred to be "gainfully employed" or to be looking for work. The credit is generally equal to 20% of the first $3,000 of qualified expenses for one dependent and $6,000 for two or more dependents.

4. Adoption credit: Parents who adopt a child may be entitled to some tax relief. The adoption credit can be claimed for up to $16,810 of qualified adoption expenses, including costs for reasonable and necessary adoption fees, attorney fees and other related expenses. However, the tax benefits of the adoption credit are phased out for both single and joint filers with a MAGI above $252,150.

5. Retirement Savings Contribution Credit: Some taxpayers are in line for a little-known tax credit for making elective contributions of up to $2,000 to qualified retirement plans ($4,000 for joint filers). This includes contributions to 401(k), 403(b), 457(b), SIMPLE and SEP plans as well as traditional IRAs and Roth IRAs. A taxpayer may also claim the credit for voluntary after-tax contributions to qualified plans. The credit percentage ranges from 50% to 10% depending on AGI.

Beginning in 2027, this credit will be replaced by a "matching" provision paid by the federal government.

Finally, other credits— such as the foreign tax credit and an extra credit for caring for the elderly or disabled—are also available to some taxpayers on their 2024 returns. Obtain more details from your professional tax advisors.

New Law Provides Disaster Tax Relief
Tax breaks salvaged on 2024 returns

What a year it was for natural disasters. Five hurricanes made landfall in the U.S. Floods, tornadoes and severe storms. And then wildfires raged on the West Coast. Millions of victims suffered damage to homes and other personal property.

At least there is a tax ray of hope. Under new legislation passed in the waning days of 2024—the Federal Disaster Tax Relief Act (FDTRA)—individuals may qualify for enhanced tax relief.

Background: Prior to the Tax Cuts and Jobs Act (TCJA), an itemizer could deduct losses to personal property that were caused by a "sudden, unexpected, or unusual" event. Typically, this included damage or destruction from natural disasters, but also applied to, say, an automobile collision or water pipes bursting during a winter freeze.

The amount of deductible loss, which was reduced by any insurance reimbursements you received, was further limited by these two rules.

- Only the excess above 10% of your adjusted gross income (AGI) was deductible.
- The amount of the loss had to be reduced by $100 for each event.

For instance, if your AGI was $100,000 and you incurred an $11,000 unreimbursed loss, your deduction was only $900.

However, the TCJA suspended the casualty loss deduction rules for 2018 through 2025, with an exception for losses in federally-designated disaster areas. In those situations, you could still deduct casualty losses to personal property, subject to the prevailing limits.

Tax update: The FDTRA allows you to deduct a loss in a federal disaster area without imposing the usual 10%-of-AGI threshold. What's more, the deduction is available whether you itemize or not. Therefore, you can also benefit from a reduction in AGI for other tax purposes. On the downside, the amount per casualty you must subtract is increased from $100 to $500.

Let us go back to our previous example where you have an AGI of $100,000 and a $11,000 casualty loss in 2024. Under the new law, you can deduct $10,500 instead of $900—or $9,600 more.

As things stand now, the new law applies to losses in qualified disaster areas from December 28, 2019, through December 12, 2024, and ending no later than January 11, 2025. But this may be revised to include losses due to the California wildfires that started after the end date. In any event, some taxpayers may benefit by filing amended returns for prior years.

Special rule: Generally, a casualty loss is claimed on the tax return for the year in which the casualty occurred. However, a special election is available for losses in a federally designated disaster area. You can choose to deduct the loss on the tax return for the year *preceding* the actual event.

For example, if you suffered a loss in January this year, you do not have to wait until you file your 2025 return in 2026 to deduct the loss. Instead, you can obtain faster tax relief by claiming the loss on your 2024 return.

Final words: If you have any questions regarding your personal situation, do not hesitate to contact your professional tax advisors.

Avoiding Estate Tax on Life Insurance
Planning ahead for your family's future

Typically, if you are one of the main breadwinners in your household, you may seek to protect the rest of the family by securing adequate life insurance. But what about federal estate tax consequences? If you are not careful, these tricky rules can dilute the benefits.

Fortunately, with the proper planning, your beneficiaries should be able to receive the life insurance proceeds without any tax erosion.

Background: Your gross estate includes the proceeds from a life insurance policy on your life if those proceeds are payable to the estate (or are received by someone else for the benefit of the estate). Obviously, it is relatively easy to avoid a potential problem by designating beneficiaries other than the estate and giving them full control over the proceeds. In other words, this condition is satisfied if you simply name a spouse or child as a beneficiary with the freedom to use the funds as they see fit. But that is only part of the story.

Even if the proceeds are not receivable by the estate, they are included in the insured person's taxable estate if the insured possessed an "incident of ownership" in the policy on the date of death. This also applies to any incident of ownership transferred within three years of death.

What is an "incident of ownership"? The term does not just mean technical legal ownership. It refers to the right to the economic benefits of a policy. The list of incidents of ownership includes such items as the power to—

- Change beneficiaries;
- Revoke an assignment;
- Obtain a loan against the cash value;
- Pledge the policy for a loan; and
- Surrender or cancel the policy.

The estate tax problem may be avoided by establishing an irrevocable life insurance trust (ILIT) as the owner of the policy. With an ILIT, you give up incidents of ownership rights under the direction of a trustee you appoint. But there is no going back when ownership rights are transferred to the ILIT.

Caution: If you acquire a life insurance policy on your life and you transfer all incidents of ownership in your policy within three years before your death, the proceeds are still included in your taxable estate. In addition, the transfer is subject to gift tax, but the overall tax bite generally is much lower than the estate tax that would be imposed if you had retained the policy. Furthermore, the transfer may be sheltered from gift tax by the annual gift tax exclusion ($19,000 per recipient in 2025) and the unified estate and gift exemption ($13.99 million in 2025).

Obviously, this setup requires careful planning and coordination between financial and tax aspects. Seek professional assistance when it is appropriate.

Seek Tax Shelter on Home Sale
Keys to unlock big tax break

Has the value of your home skyrocketed in the past few years? You may think this is a good time to sell and either upgrade or downsize. If you do, you will be eligible for one of the "biggest and best" tax breaks on the books: the home sale exclusion.

Under this long-standing tax law provision, a taxpayer can exclude from federal income tax up to $250,000 of gain from the sale of a home if certain requirements are met. The exclusion is doubled to $500,000 for couples that file a joint return. So, if you and your spouse are careful, you can pocket up to half a million dollars tax-free!

Background: To qualify for the home sale exclusion, the home must have been owned by you and used as your "principal residence" at least two of the five years prior to the sale. This special tax exclusion does not apply, however, if you sold another qualified principal residence within the last two years. (Theoretically, you could qualify for the home sale exclusion every two years.)

Keeping that in mind, here are several key points to know about the home sale exclusion:

- The home must be used as your principal residence for any two of the previous five years, but the years do not have to be consecutive. Furthermore, you can meet the "use" and "ownership" requirements in different tax years.

- If you file a joint return, you can claim the maximum exclusion if (1) either spouse meets the two-year ownership test, (2) each spouse meets the two-year use test and (3) neither spouse has elected the exclusion within the last two years. This is particularly important to remember if you have recently divorced or remarried.

- To meet the "use" requirement, you must physically occupy the home, but short absences do not work against you. On the other hand, a longer absence, such as a one-year sabbatical by a college professor, does not count as time that the home is being used as your principal residence.

- If you own two homes and live in both places during the year, the home where you stay for most of the year is generally treated as your principal residence. For instance, if you spend seven months at a winter home and five months at a summer home, the winter home is considered to be your principal residence. Be careful to document your stays.

- To the extent that the home has been used for business rental or use—including using a portion of the residence as a home office—you must recapture depreciation deductions attributable to the period after May 6, 1997. The recaptured income is taxable at the 25% rate.

- In some cases, you may qualify for a partial exclusion without meeting the usual two-year rule if you sell the home sooner due to a change in employment, health reasons or other unforeseen circumstances.

Reminder: Of course, this is only a brief overview of the tax exclusion for the sale of a principal residence. It is recommended that you consult with a professional tax advisor concerning all the tax ramifications of home ownership, including tax benefits that may be available on your 2024 return.

Tax Breaks for a New Business

Generally, a new business can deduct up to $5,000 of its start-up costs on a 2024 return, subject to a phase-out above $50,000. The remainder is amortized over 180 months.

But certain other expenses in the first year of operation may be deductible. This includes:

- Incorporation expenses;
- Expenses for interest, real estate and research and development (R&D); and
- Costs attributable to the acquisition of property eligible for depreciation or other cost recovery provisions.

Special rules and limits are likely to come into play. Obtain expert tax guidance.

Facts and Figures
Timely points of particular interest

Get a Fresh Start—Under the IRS "Fresh Start" initiative, individuals who owe back taxes to the IRS—including interest and penalties—may be able to settle or pay down the debts through installment agreements, the Offer-in-Compromise (OIC) program or similar plans. But there is some movement in the federal government to reduce the availability of the Fresh Start and OIC programs or eliminate them altogether. If these plans would provide benefits for someone in your family, have them contact a tax professional sooner rather than later.

Catch-Up Contributions—The IRS recently issued new proposed regulations relating in part to catch-up contributions made to 401(k) and certain other qualified plans. Under new rules taking effect in 2025, "super" catch-up contributions may be made to eligible plans by employees age 60 through 63. The limit for these super catch-up contributions is $11,250 for 2025. Super catch-up contributions can be made in addition to regular contributions. We will provide more information on the new rules in an upcoming issue.

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