ROBERT D FLACH'S THE 1040 LETTER

July 2016

Dear Taxpayer:

This month I explain how much mortgage interest you paid during the year is actually deductible, discuss a Tax Court case that concerns a tuition tax credit, list a dozen "urban tax myths", and introduce you to a unique newsletter for NJ state taxpayers.

Your thoughts, comments, and suggestions on the topics discussed in this issue are welcomed. Email me at **rdftaxpro@yahoo.com** with "The 1040 Letter" in the subject line. You can also email me with any tax questions you would like me to address in future issues.

DEDUCTING MORTGAGE INTEREST

In my opinion **the area of the Tax Code where proper documentation and strict adherence to the law is perhaps the most overlooked (or actually ignored) is the deduction for mortgage interest** – both on Schedule A and Form 6251 (Alternative Minimum Tax-Individuals).

As a reminder – there are three (3) kinds of mortgage debt –

1) Grandfathered debt – debt acquired on or before October 13, 1987, that was secured by a main residence or a qualified second home. It doesn't matter what the proceeds of the loan were used for, as long as the debt was secured by the property.

2) Acquisition debt - debt acquired after October 13, 1987, that was used to buy, build, or substantially improve a main residence or a qualified second home. A "substantial improvement" is one that adds value to the home, prolongs the home's useful life, or adapts the home to new uses.

3) Home equity debt – debt acquired after October 13, 1987, that is secured by a main residence or a qualified second home and is not used to buy, build, or substantially improve the property. There is no restriction or limitation on what the money can be used for; you can use it to buy a car, to pay for college, or to pay down credit card balances.

Interest on home equity debt is not deductible in calculating the dreaded Alternative Minimum Tax (AMT)

Taxpayers are required to keep separate track of acquisition debt and home equity debt, to make sure that the deduction on Schedule A does not include interest on debt principal that exceed the statutory maximums ($1 Million for acquisition debt and $100,000 for home equity debt – no limit on grandfathered debt), and to determine what interest deduction to add back on Form 6251 when calculating Alternative Minimum Taxable Income.

I firmly believe that 99.5% of taxpayers do not do this. I do not know of any taxpayer who does.

And I expect that the majority of tax preparers do not do this for their taxpayer clients.

Most taxpayers, and a large percentage of tax preparers, merely take the amount of “Mortgage interest received from payer(s)/borrower(s)” reported in Box 1 of the Form 1098 Mortgage Interest Statements and enter it on Line 10 of Schedule A.

And similarly, most taxpayers, and a large percentage of tax preparers, do not include any adjustment to the Schedule A mortgage interest deduction on Line 4 of Form 6251.

It is sometimes easy to identify the difference between acquisition debt and home-equity debt if the taxpayer has one acquisition mortgage and a separate home equity loan and/or line of credit. But home equity debt often arises from multiple refinancings and consolidations over an extended period of years.

To be fair to my fellow tax preparers, many do not adjust the Schedule A or Form 6251 deduction for home equity interest because their clients have not kept track of the separate types of debt and therefore do not provide separate principal or interest numbers.

The responsibility for keeping separate track of the two types of mortgage debt (actually three if you consider “grandfathered” mortgage debt) truly lies with the taxpayer client and not the tax preparer.

Obviously the best solution to this issue is to have boxes on the Form 1098 for “acquisition debt” principal and interest and “home equity debt” principal and interest, and require banks and other mortgage providers to properly report these amounts thereon. But this would require a lot more information gathering and paperwork on the part of mortgage providers, and I doubt if the banking lobby would allow a law requiring this additional reporting to pass.

I have created a “Mortgage Interest Guide” as part of my collection of Tax Deduction Guides. In this guide I explain the various types of mortgage debt and the deduction limitations, and go into detail on how refinancing an acquisition debt mortgage can result in home equity debt.

I also include in this guide two worksheets – one for Acquisition Debt Activity and one for Home Equity Debt activity – and provide a detailed example of how to use the debt activity worksheets. These worksheets will allow homeowners to keep a detailed record of the two types of mortgage debt – so that they will be able to properly complete their tax returns, or to provide the necessary information to their professional tax preparers.

The cost of this Mortgage Interest Guide sent as a pdf email attachment is **only $2.00!** A printed copy sent via postal mail is $4.00. {Click **here** to check out my other Tax Deduction Guides}

I have also written a more detailed **TAX GUIDE FOR NEW HOMEOWNERS** that covers all of the special tax benefits available to homeowners, including -

- itemized deductions for real estate taxes, mortgage interest, refinancing, points, and mortgage insurance premiums
- the home office deduction,
- rental income and deductions for a 2-family home,
- the home sale exclusion, and
- Alternative Minimum Tax issues.

This guide also contains sections on “Choosing A Tax Professional” and “What’s New In Taxes for 2016” and “What’s New In Taxes for 2017” and special worksheets, with detailed instructions, on how to keep track of the different types of mortgage interest.

The cost is $7.95 sent as pdf email attachment and $9.95 for the print edition.

Send your check or money order for $2.00, or $4.00, or $7.95 or $9.95, payable to TAXES AND ACCOUNTING, INC, and your email address or postal address to –

MORTGAGE INTEREST GUIDE (or TAX GUIDE FOR NEW HOMEOWNERS)
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POST OFFICE BOX A
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CHECK OUT MY BLOG "**THE WANDERING TAX PRO**" FOR UP-TO-THE-MINUTE ADVICE, INFORMATION, RESOURCES, AND COMMENTARY ON FEDERAL TAXES AND UPDATES ON FEDERAL TAX LEGISLATION, IRS RULINGS AND REGULATIONS, AND FEDERAL TAX COURT DECISIONS.

TAX COURT RULES ON EDUCATION TAX CREDIT

Terrell, T.C. Memo.2016-85 verified the fact that **an education tax credit is based on the amount actually paid by or for the student and not the amount billed.**

IRS information return 1098-T is supposed to provide information for claiming the various education tax benefits. Unfortunately this form has usually been **as useful in properly calculating a tax benefit as tits on a bull.**

Box 1 of the 1098-T is for payments received "from any source" (**by** the student or the student's family, or **for** the student, such as via student loan proceeds) for qualified tuition and related expenses during the calendar year. This is the information I need. However in the years that this form has been in use I have only seen an entry in this box a handful of times – and it was often incorrect.

Box 2 is for amounts "billed" for qualified tuition and related expenses. This is the box that is always filled in. Colleges generally bill students for the semester beginning in January of the following year at the end of the current year. So the amount in Box 2 usually includes this amount, whether or not actually paid during the calendar year. But my clients are "cash-basis" taxpayers. I don't give a rat's hind quarters how much was "billed" – I need to know how much was paid.

The Form 1098-T issued by the university to the taxpayer in Terrell reported only the amount of qualified tuition and fees "billed" in tax year 2011. However student loan proceeds were issued to the school in payment of tuition and fees for 2011 billed in 2010 in January of 2011 – and the amount actually paid in 2011 was more than twice as much as the amount reported on the 2011 Form 1098-T. The taxpayer claimed a credit based on the amount paid, but the IRS reduced the credit based on the amount reported on the Form 1098-T.

In the decision the Court explained that as the taxpayer in the case was a "cash-basis" taxpayer, as most taxpayers are, and, as the student loan proceeds were paid to the school in January of 2011, under IRS Regulation section 1.25A-5€(3), this amount should be used to calculate the allowable credit. **The court affirmed that the amount billed to the taxpayer during the year does not control the size of the credit – the credit is based upon the amount paid, and not the amount billed.**

A 2015 law change requires that, beginning with tax year 2016, **an individual must have received a Form 1098-T from a qualified educational institution in order to claim an education tax benefit.** Thankfully, the required 1098-T also **must now include an entry in Box 1.** However the new requirement may cause a problem for taxpayers claiming the American Opportunity Credit (AOC).

The AOC is based on qualified post-secondary educational expenses, net grants and scholarships, of up to $4,000. Qualified expenses for the AOC include required books, supplies, and equipment. However the Form 1098-T only shows tuition and fees paid to the college or university – it does not include any books, supplies, or equipment. The IRS will be matching the numbers reported on Form 1098-T to the numbers reported on Form 8863. If a taxpayer needs to include the costs of books, etc to reach the $4,000 maximum for the AOC the numbers will not match and the IRS may disallow that portion of the credit based on these costs.

I recommend that if you are using the costs of required books, etc as part of the base amount for the AOC you should attach a statement to the Form 1040 or Form 1040A filing explaining this and separately identifying the Form 1098-T tuition and fees amount and the amount claimed for books, etc.

A DOZEN URBAN TAX MYTHS

Take whatever you hear or read about taxes from anyone other than a qualified tax professional with several grains of salt. Like what you're liable to read in the Bible, it' ain't necessarily so!

1. Receiving a Form 1099 increases your audit risk.

The mere receipt of a Form 1099 does not in any way affect your audit profile. However, if you don't report the income from a Form 1099 on your 1040 you will eventually receive a bill from Uncle Sam for additional tax and accrued penalties and interest.

2. You only have to claim the income for which you receive a Form 1099.

All income from self-employment, and most interest and dividends, is taxable — whether or not you receive a Form 1099.

3. Filing late means you're less likely to be audited.

Just because you file late in the season, near the April 15th deadline, does not mean you have decreased your audit risk. And requesting an extension, and filing your return close to Oct. 15, doesn't decrease your audit risk either. You get audited based on what is on your return, not when you filed it.

4. If the IRS didn't audit your returns, the deduction you've been taking all these years must be legal.

It just means you weren't caught ... yet.

5. Claiming a home office deduction automatically triggers an audit.

Before the rules were clarified in the '90s, the home office deduction was considered an audit "red flag." Not anymore. In my 40+ tax seasons of preparing 1040s, none of my clients have ever been questioned or audited by the IRS for claiming a home office deduction.

6. Working taxpayers older than 65 don't have to pay Social Security tax.

Salaries and wages are subject to FICA (Social Security and Medicare) Tax whether you are 3 years old or 101 years old, and regardless of whether or not you are collecting Social Security. I actually had an employee at one of my business clients tell me several years ago that since she was 70 I do not have to withhold Social Security tax from her paycheck anymore. This myth stems from the fact that at one time retirees 72 or older (now 65 or older) did not have to reduce or repay Social Security benefits due to excess earned income.

7. You can deduct the cost of your car and all its operating expenses, or the standard mileage allowance, as a business expense if you put advertising on the car.

IRS Publication 463 states the facts: "*Putting display material that advertises your business on your car does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you still cannot deduct your expenses for those uses*."

8. You can claim a tax deduction for making a gift of up to $14,000 to your son or daughter.

You can never deduct a gift to an individual on your income tax return. This applies only to the federal "Gift Tax" – you can currently make a gift of $14,000 per person per year without having to pay Gift Tax (this number may be adjusted annually for inflation).

9. The Alternative Minimum Tax (AMT) is only for high-income taxpayers.

The AMT was originally intended to make sure high-income individuals did not use tax shelters and loopholes to avoid paying their share of federal income tax. But that is no longer the case under current law. My millionaire clients never pay AMT – but many in the middle and upper-middle class have become victims of this dreaded alternate tax system.

10. "What do you mean it's wrong? I used Turbo Tax!"

The Tax Court has on several occasions rejected the "Turbo Tax Defense" when a taxpayer attempted to blame tax preparation software for errors made on a tax return. If you rely on a "box" to prepare your tax returns remember – garbage in, garbage out.

No software package, or tax filing "app" or online filing service, is a substitute for knowledge of the Tax Code, and no tax software package, or tax filing "app" or online filing service, is a substitute for a competent, experienced tax professional.

11. You can settle your outstanding IRS tax debt for "pennies on the dollar".

Don't believe ads for companies that make such a claim. It sounds too good to be true, and it is! These ads refer to an IRS program known as "Offer In Compromise," but no matter what they say, the IRS isn't going to let you pay $100 to settle a $50,000 tax debt. If you use one of these companies you will pay a sizable fee – after all, how do you think they afford to advertise on TV? Several of the companies promising to settle IRS debt for "pennies on the dollar" have gotten into legal trouble for taking advantage of their customers and have been shut down.

12. CPAs are 1040 tax experts.

The initials "CPA" have nothing whatsoever to do with one's knowledge of, experience with, or ability to prepare 1040s. All they mean is that the person can certify financial statements. A CPA passed a very difficult test on accounting issues, perhaps dozens of years ago, with minimal, if any, questions on 1040 taxation. CPAs must maintain minimal annual continuing professional education (CPE) credits – but **there is nothing that says any of their CPE must be in 1040 taxation.** There are many CPAs who are also 1040 tax experts, **but it has nothing to do with their "initials."**

The only "initials" that have any bearing on a person's competence and currency with federal individual income tax law are "EA" – for Enrolled Agent and ATP (**Accredited Tax Preparer**) and ATA (**Accredited Tax Advisor**).

THE NJ-1040 LETTER

You are paying too much New Jersey state income tax – and it's nobody's fault but your own!

Most NJ taxpayers concentrate on their federal tax return and spend minimal time on their NJ return, simply taking numbers from the 1040 and putting them on the NJ-1040. As a result they are paying more NJ state tax than necessary, often paying tax on income that is not even taxed by NJ.

By becoming informed on NJ state tax law and using proper tax planning you can make sure that you pay the absolute least amount of NJ Gross Income Tax possible for your particular situation.

I have been preparing NJ-1040s for as long as there has been a NJ-1040, and federal income tax returns for even longer. I have created a new newsletter titled THE NJ-1040 LETTER to share my knowledge and experience from over 40 years as a professional tax preparer to help you experience the joy of avoiding NJ state taxes.

Published 6 times a year (January, February, March, April, July, and October), each issue will contain valuable NJ state tax-saving advice and information, updates on NJ state tax law, NJDOT rules and regulations, court cases, and the special NJ property tax relief programs, and links to online resources to help you in planning for an preparing your NJ-1040. Also included in each issue will be special forms, schedules, and worksheets to help you during the year and at tax time.

This is the only publication that I am aware of that deals exclusively with tax planning and preparation advice for the NJ-1040.

A one-year subscription to THE NJ-1040 LETTER delivered as a pdf email attachment is ***only $11.95***. A print edition sent via postal mail is also available for $24.95.

Subscribers will be offered special discounts on other tax-saving reports throughout the year.

You can download a free copy of the premiere July 2016 issue by clicking **here**.

To order your subscription send your check or money order, payable to TAXES AND ACCOUNTING, INC, for $11.95 or $24.95 and your email or postal address to –

THE NJ-1040 LETTER
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THE LAST WORD -

You MUST keep good, contemporaneous records of all your income and deductions in the manner prescribed by the IRS and the Tax Code. Some deductions require special recordkeeping or additional information, such as business meals and entertainment, business use of "listed property" (such as automobiles and computers), charitable donations, and gambling losses.

It is better to save too many receipts than too little. Even if you normally do not itemize, it is a good idea to keep records and receipts for all "itemizable" expenses just in case.

Keep records and receipts during the year assuming that your return will be audited. While chances are this will not happen, if your return is chosen for review it will be a blessing to have everything well documented in advance rather than having to start from scratch and reconstruct the necessary supportive documentation.

If you have any questions about what I talk about in this issue I suggest you consult your, or a, tax professional

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ABOUT THE AUTHOR – ROBERT D FLACH

Robert D Flach, a recent transplant from Jersey City NJ to rural Northeast PA, has been preparing 1040s for individuals in all walks of life since 1972. He is "winding down" his tax practice and no longer accepts new clients.

In 45 years of preparing individual income tax returns he has never used tax preparation software. One of the last of the dinosaurs, he prepares close to 300 sets of returns each year manually.

Robert learned how to prepare 1040s by preparing 1040s.

"On my first day at work for my uncle's tax preparer, having never prepared a tax return before, my boss led me to a desk. He gave me a copy of a client's prior year 1040 and a briefcase with the current year's 'stuff' and told me to 'jump in and swim!'"

*Robert has been writing the popular tax blog THE WANDERING TAX PRO (**http://wanderingtaxpro.blogspot.com**) since the summer of 2001. He is the creator and author of the websites FIND A TAX PROFESSIONAL (**http://www.findataxprofessional.com**) and THE TAX PROFESSIONAL (**http://thetaxprofessional.webs.com**), and is the founder of TAX PROFESSIONALS FOR TAX REFORM (**http://www.taxprosfortaxreform.com**).*

He has been a member of the National Association of Tax Professionals for over 30 years, and often write for the Association's TAXPRO JOURNAL as well as the newsletter of the New Jersey state chapter. He has created and compiled several packages of forms, schedules and worksheets and special reports and guides on tax planning and preparation for the average taxpayer.

*Robert is available to write articles and columns for websites and portals and print or email newsletters, on general tax topics, or specifically for your individual audience. You can find samples of his writings at **http://robertdflach.blogspot.com***

BOBSERVATIONS

I have created a new monthly newsletter titled **BOBSERVATIONS.**

This newsletter will contain my observations on "life, liberty, and the pursuit of happiness". In BOBSERVATIONS I talk about, and provide valuable advice, information, and resources on -

- ✓ **POPULAR CULTURE** - music, theatre, television, movies, the internet
- ✓ **PERSONAL FINANCE** - credit, savings, investing, spending, and, of course, taxes
- ✓ **POLITICS** - general political philosophy and specific political campaigns and elections
- ✓ **TRAVEL** - my past and present visits to local, national, and international locations

And whatever else tickles my fancy - including occasional ranting and whining.

The cost of this new monthly newsletter is **only $9.95 for 12 monthly issues.**

The first 100 subscribers will receive as a free gift my e-book WON'T YOU TAKE THIS ADVICE I HAND YOU LIKE A BROTHER - a compilation of my best tax advice from 45 years of preparing 1040s that currently sells for $7.95.

And **all subscribers will get a 10% discount on any of my other books, reports, guides, and compilations.**

The monthly issues of BOBSERVATIONS, and WON'T YOU TAKE THIS ADVICE I HAND YOU LIKE A BROTHER, will be delivered to you as a "pdf" email attachment.

The comments and suggestions of subscribers, which are welcomed and solicited, will be addressed in future issues.

Click **here** to download a free sample copy of the premiere issue of BOBSERVATIONS for your review. Check it out - what have you got to lose?

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