CPA

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

October 2013

Tax Planning for Same-Sex Spouses

The Supreme Court ruled in June this year (*Windsor*, No. 12-307 (U.S. 6/26/13)) that Section 3 of the federal Defense of Marriage Act (DOMA) was unconstitutional. This decision has many consequences, including a major impact on tax law.

Under the *Windsor* decision, same-sex marriages will be recognized for federal tax purposes if the couple was married in a state that permits same-sex marriages and still lives in such a state.

Example: Judy Adams and Kathy Benson were married in Maine and still live there, so they qualify for federal tax treatment as a married couple. The same would be true if they moved to Minnesota.

However, if this couple had moved to, say, Indiana, where such marriages are not allowed, their status would be unclear. Under Section 2 of DOMA (not struck down by the Court), Indiana doesn't have to recognize their Maine same-sex marriage. Whether they would still be recognized as married for federal purposes was not addressed by the Court. It is also unclear how the decision applies to the status of same-sex couples in civil unions and domestic partnerships in states that recognize those relationships.

Going forward, the federal government may issue clarification on these points. For now, same-sex couples who were married and still reside in states recognizing their marriages qualify for federal tax treatment. Following are some of the key changes.

continued on page 2

What's Inside

Going Through the Roof

Among U.S. cities with at least 33% of the population age 65 or older, home prices are rising fastest in Dunnellon, Florida, where they increased more than 31% in the 12 months through May 2013.

continued from page 1

Income tax

Legally married couples can't file as single taxpayers. Instead, they can file joint returns or use the "married filing separately" status.

Generally, joint tax returns will produce a lower tax bill. However, if both spouses have high incomes, combining their earnings on a joint return may lead to a larger tax bill. Similarly, married individuals might be better off filing separately if one spouse has substantial itemized deductions, such as unreimbursed medical expenses.

Estate and gift tax

The Supreme Court's decision in *Windsor* actually resulted from an estate tax case. Edith Windsor brought the action, seeking to recover $363,000 in federal estate tax she had paid after her spouse's death in 2009.

Under federal law, a deduction (the marital deduction) generally is allowed for estate tax purposes for the value of bequests to a surviving spouse, regardless of the amount involved. The marital deduction makes it possible for spouses to leave assets to each other without incurring a federal estate tax obligation. Under the holding in *Windsor*, the marital deduction now applies to same-sex couples. Moreover, the "portability" section of the tax code now applies to same-sex married couples as well: the second spouse to die can use the other spouse's unused federal estate tax exemption, with proper planning.

Gifts between spouses now are also tax exempt. Thus, Judy Adams from our example can give her spouse, Kathy, more than $14,000 this year without having to be concerned about filing a gift tax return or losing some of her estate tax exemption. Moreover, unlimited tax-free gifts between spouses may give some same-sex couples more flexibility in their estate planning.

Same-sex couples now can split gifts, too. If Judy wants to give her niece $28,000 this year, to help pay for college or buy a condo, Kathy can elect to absorb half the gift, for tax purposes, so neither spouse will have exceeded the current $14,000 annual gift tax exclusion.

Employee benefits

The Supreme Court's decision will also affect the tax treatment of employee benefits. Same-sex spouses who paid tax on imputed income from group health insurance coverage no longer will have to do so, for example. Medical expenses incurred by same-sex spouses now can qualify for pretax reimbursement from flexible savings accounts and health savings accounts.

Beyond health benefits, same-sex spouses have new status in relation to qualified retirement plans such as 401(k)s. In most cases, spouses are entitled to survivor benefits, to veto power over plan loans, and to joint pensions. A spouse's consent is usually necessary, therefore, if a married plan participant wants to name a nonspouse as primary retirement account beneficiary or wants to retire with a single life annuity.

Therefore, same-sex spouses should go over their employee benefits carefully. If a nonspouse is currently the retirement plan beneficiary, for instance, the plan participant should either name the spouse as the new primary beneficiary or obtain a written consent from the spouse to retain the nonspouse as the beneficiary, according to the plan's rules.

IRAs

As *Individual* Retirement Accounts, IRAs do not have the same spousal privileges and requirements that bind employer plans such as 401(k)s. Nevertheless, same-sex couples will enjoy some easing of IRA restrictions.

- **Contributions.** Individuals with no earned income can't contribute to IRAs. A worker's spouse can, however. Thus, if Judy works while Kathy stays home to do household tasks, both spouses can make full contributions to IRAs.
- **Distributions.** After age 70½, IRA owners must take taxable required minimum distributions (RMDs). An IRA owner with a spouse more than 10 years younger can take smaller RMDs, leaving more money in the tax deferred IRA.
- **Beneficiaries.** A surviving spouse can roll an inherited IRA to his or her own name, designate new beneficiaries, and perhaps delay RMDs. A nonspouse IRA beneficiary does not have this privilege. ■

Don't Waste 529 Tax Benefits

Qualified tuition programs (QTPs), also known as 529 plans, offer substantial tax benefits. Investment earnings inside such plans avoid income tax. In addition, distributions from 529 plans to cover qualified higher education costs are tax-free.

However, you'll lose the full value of 529 tax benefits if you're not careful about managing distributions. One trap is taking out too much money; another involves not pulling enough money from your 529.

Expensive excess

The risk of insufficient 529 withdrawals may be easier to grasp. If you leave money in the account after all the relevant college bills have been paid, further distributions may be highly taxed.

Example 1: Art and Kim Wilson open up a 529 account for their daughter, Eve. After Eve graduates and gets a full time job, there is still $20,000 left in the 529 account. The senior Wilsons have no younger children to whom they might transfer the account.

If the Wilsons want to use that $20,000 for purposes other than education, distributions will be taxable. The taxable amount will depend on the ratio of earnings to the overall account value. The Wilsons also will owe a 10% penalty on the amount included in income.

Qualified (that is, tax-free) distributions from a 529 plan may cover tuition, fees, books, supplies, and equipment, as well as room and board, in many cases. However, money spent by the Wilsons or by Eve to repay student loan debt will not be considered a qualified 529 expense, for this purpose. Ideally, 529 account owners should fully draw down 529 accounts for qualified higher education costs before all the likely beneficiaries are finished attending classes.

Credit check

Another 529 tax trap involves other college tax breaks such as the American Opportunity Tax Credit, the Lifetime Learning Tax Credit, and the tuition and fees tax deduction. Many taxpayers can save taxes by claiming such benefits. For instance, the American Opportunity Tax Credit is fully available to joint filers with modified adjusted gross income (MAGI) of $160,000 or less, and to single filers as well as household heads with MAGI of $80,000 or less. (Partial credits are available with slightly higher income.) Someone who qualifies can trim taxes by as much as $2,500, on $4,000 worth of higher education outlays.

However, you can't claim these education tax benefits and 529 qualified distributions for the same expenses. To claim either credit or the deduction, you may owe tax on your 529 distribution.

Example 2: Eve Wilson's total qualified college costs in 2013 are $25,000. Her parents take a $25,000 distribution from their 529 account to pay those bills. When the senior Wilsons file their 2013 tax return, they discover they are eligible for a full American Opportunity Tax Credit, which they claim.

Because the Wilsons use $4,000 of Eve's qualified expenses to claim the tax credit, only $21,000 of their 529 withdrawal counts as a qualified distribution. Thus, the Wilsons must treat $4,000 as a nonqualified distribution. (Note: Taxpayers won't owe the 10% penalty if they lose the 529 tax break because of a conflict with the American Opportunity Tax Credit.)

If the Wilsons had been aware of this tax treatment, they could have paid $4,000 of Eve's college bills from another source to align with the American Opportunity Tax Credit. Then they could have withdrawn only $21,000 from the 529 plan, all of which would have been tax-free.

Our office can help you determine which accounts to tap for college bills to maintain maximum tax efficiency. ■

Trusted Advice

Family QTP Transfers

- Assets in a Qualified Tuition Program (QTP) can be rolled over or transferred from one QTP to another. In addition, the designated beneficiary can be changed without transferring accounts.
- There are no income tax consequences if the designated QTP beneficiary is changed to a member of the existing beneficiary's family.
- A beneficiary's family includes many relatives, for this purpose. Besides children, stepchildren, foster children, and adopted children, the extensive list includes parents, siblings, in-laws, and their spouses.

IRS Approves Simpler Home Office Deductions

Deducting legitimate expenses for a home office isn't easy, but it can be done. Millions of taxpayers (including self-employed individuals and business owners) claim such deductions each year. Moreover, the process may be easier for 2013 and future years, thanks to an IRS ruling.

In Revenue Procedure 2013-13, the IRS spelled out an optional method to report expenses for business use of your home. The process is simple, to say the least: you find the size of your home office and multiply the square footage by $5.

Example: Sarah Williams keeps an office in her home. She measures the space at 225 square

continued on page 4

continued from page 3

feet. Multiplying 225 by $5, Sarah calculates and claims a deduction of $1,125 on her 2013 income tax return. The IRS calls this a safe harbor method, meaning that Sarah doesn't need to show $1,125 of expenses related to the business use of the home.

Assessing the advantages

Simplicity is the prime advantage of the safe harbor method. Under prior law, taxpayers had to fill out IRS Form 8829, which has more than 40 lines, in order to claim home office deductions. If you use the safe harbor method, you won't have to deal with Form 8829. You can, if you wish, go back and forth between Form 8829 and the new safe harbor method, from one year to the next.

What's more, you also can deduct other expenses of your business that are not related to the business use of your home. Such deductions could include advertising and supplies, for example. In addition, if you itemize expenses on Schedule A of Form 1040, you can include all of your mortgage expenses, real estate taxes, and casualty losses. Taxpayers using Form 8829 must allocate such expenses between business and personal use.

Now for the negatives

Using the safe harbor method will be simpler but may not be better. Under the new rules, the home office deduction is limited to home offices of 300 square feet, for a maximum deduction of $1,500. That's true even if your home office is larger.

When you use this safe harbor deduction, you can't take depreciation deductions for your home office.

Altogether, it's possible that your annual deductions will be less, if you use the safe harbor method, compared to the deductions you can claim by filling out Form 8829. Maximizing business expenses on Form 8829 may have secondary benefits, too. You'll reduce your business income, which may decrease your self-employment tax obligation. You'll also reduce your adjusted gross income, which may generate more tax deductions and tax credits elsewhere on your tax return.

Ground rules

Regardless of whether you use Form 8829 or the safe harbor method,

you'll have to pass certain tests to qualify for home office deductions. For example, the space in your home that's used as an office must be used regularly and exclusively for business. After clearing this hurdle, a home office must be either the principal place of business; a place used by patients, clients, or customers in the normal course of business; or in a separate structure where business is conducted. If you're an employee, you'll be entitled to a home office deduction only if the office is for the convenience of your employer. In any case, your home office deduction can't exceed the gross income from the related business.

Our office can help you determine whether the safe harbor option is desirable for you. ■

TAX CALENDAR

OCTOBER 2013

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2012, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2012 calendar year tax return(Form 1065-B).

October 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2013. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 12 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

NOVEMBER 2013

November 12

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2013. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

The *CPA Client Bulletin* (ISSN 1942-7271) is prepared by AICPA staff for the clients of its members and other practitioners. The *Bulletin* carries no official authority, and its contents should not be acted upon without professional advice. Printed in the U.S.A. Sidney Kess, CPA, JD, Editor. For AICPA customer service, call 888.777.7077 or visit *www.cpa2biz.com*.