MARRIAGE

Wolters Kluwer

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The moment you say "I do" not only changes your personal life, but your tax status too. Although taxes are probably not one of the first things that newly married couples think about, the change of your marital status from single to married brings with it many tax advantages, and a few disadvantages too.

This guide will help you understand how marriage impacts:

- Filing Status;
- Joint Returns;
- Separate Returns;
- Community Property;
- Family Business; and
- Estate Planning.

FILING STATUS

Your filing status determines the federal tax rate on your taxable income. It also affects the standard deduction you may claim, and whether you are eligible to claim certain other deductions and credits. If you are married, the filing choices are married filing a joint return and married filing separate returns.

Your marital status is determined on the last day of the tax year, unless your spouse dies during the tax year. In that case, your marital status is determined as of the date of your spouse's death, and you may be considered married for the tax year and eligible to file a joint return with your deceased spouse, unless you remarry during the year.

> ***Comment.*** Whether a marriage is recognized for federal tax purposes depends on state law. If you and your spouse are legally married in a state, including a same-sex marriage, then the marriage is recognized for federal tax purposes, even if you reside in another state.

You are considered married if you are separated from your spouse but have not obtained a final decree of divorce or separate maintenance by the last day of your tax year. On the other hand, if you are married and did not live with your spouse during the last six months of the tax years you may be considered not married and use the head of household filing status. To qualify, you must maintain your home for more than half of the tax year as the principal place of adobe of your child (or other dependent).

Comment. An individual filing as head of household is generally entitled to a lower tax rate and higher standard deduction than filing as a single taxpayer.

Tax rates

There are seven tax rates for individuals: 10%, 15%, 25%, 33%, 28%, 35%, and 39.6%. The taxable-income levels at which these rates begin and end are adjusted annually for inflation. In determining whether to file as married filing jointly or married filing separately, you may find that the taxable-income levels produce a marriage penalty or marriage bonus.

A marriage penalty exists when the tax on the combined income of you and your spouse when filing jointly exceeds the sum of the tax that would be file if you each file separately. On the other hand, a marriage bonus may occur if you and your spouse pay less tax by filing jointly than you would have if each of you filed separately.

Comment. The marriage penalty may not affect you. It usually affects two-income households. Couples that earn approximately the same income are hit hardest. If only you or spouse works, you will usually pay less income tax by filing a joint return.

While the income levels for married individuals filing jointly are larger than those applicable to single taxpayers, they are not always double. For example, the tax brackets for the five highest tax rates (25%, 33%, 28%, 35%, and 39.6%) for married individuals filing jointly are less than twice the amount of the brackets if filing separately. On the other hand, the tax brackets for the two lowest rates (10% and 15%) for married filing jointly is roughly twice the amount of the bracket if married filing separately.

Example. The 10% rate applies in 2013 to the first $8,925 of taxable income if you are married filing separately, and $17,850 if you are married filing jointly. The 10% rate applies in 2014 to the first $9,075 of taxable income if you are married filing separately, and $18,150 if you are married filing jointly.

Standard deduction

Generally, you have the choice of itemizing your allowable deductions or claiming a standard deduction whichever one lowers your tax liability the most. The amount of the standard deduction depends on your filing status.

If you file as married filing jointly, your standard deduction is $12,200 for 2013 and $12,400 for 2014. If you file as married filing separately, your standard deduction is only $6,100 for 2013 and $6,200 for 2014.

Caution. If you and your spouse file separate returns and one of you itemized deductions, then the other spouse cannot claim the standard deduction and must also itemize deductions.

Other taxes

In addition to your regular tax liability, you may also be liable for two other federal taxes which are dependent on your filing status. First, a 3.8% tax is imposed if your modified AGI exceeds certain threshold amounts depending on your filing status. The tax is imposed on the lesser of your net investment income (NII) or your AGI in excess of the threshold amounts. The threshold is $250,000 if you are married filing jointly, and $125,000 if you are married filing separately.

Second, the tax rate on your share of FICA (employment) taxes for Medicare is increased 0.9% (from 1.45% to 2.35%) if the wages you receive from your employers exceeds certain threshold amounts depending on your filing status. The threshold is $250,000 if you are married filing jointly, and $125,000 if you are married filing separately. In the case of a joint return, the additional 0.9% Medicare tax is on the combined income of you and your spouse.

JOINT RETURNS

If you are married at the close of a tax year, you may file a joint return. Generally, it is more beneficial for married individuals to file a joint return as tax rates are sometimes higher when married individuals file separate returns. In addition, some tax credits and deductions may be limited or disallowed for married individuals filing separately.

Who may file?

You and your spouse may file a joint return even though one of you has no income or deductions, but only if:

(1) Your tax years begin on the same date (the vast majority of individuals are on a calendar year);
(2) You are not legally separated under a decree of divorce or separate maintenance on the last day of the tax year; and
(3) Neither of you is a nonresident alien at any time during the year (but see the discussion below of the election to file jointly with a nonresident spouse).

Accounting methods. You and your spouse may file a joint return even though you have different accounting methods (for example, where you are on the cash basis and your spouse is on the accrual basis for some business

reason) if those methods clearly reflect your income.

If you file jointly, you both must include all your income, exemptions, deductions, and credits on that return.

Separation. If you and your spouse are not living together on the last day of the tax year, you may still file a joint return if you are not legally separated under a decree of divorce or separate maintenance on that date. Spouses who are separated under an interlocutory decree of divorce are considered husband and wife and are entitled to file a joint return until the decree becomes final.

Joint liability

Both you and your spouse are responsible, jointly and individually, for the tax and any interest or penalties due on your joint return. That is, one spouse may be held liable for all the tax due even if the other spouse earned all the income.

> ***Caution.*** Both you and your spouse must sign the return or it will not be considered a joint return.

Citizenship

At least one of you must be a U.S. citizen or resident at the end of the tax year to file a joint return. If either you or your spouse is a nonresident alien, you may elect to file jointly by attaching a statement to your return, which you both sign. The election applies to all subsequent years until terminated by revocation, death, separation or divorce, or termination by the IRS for failure to keep adequate records. Once the election is terminated, it may not be made again by the couple.

If you make the election to file a joint return, both you and your spouse will be subject to tax on your worldwide income even if one of you is not a citizen. Nonresident aliens generally are subject to U.S. income taxation only if they have U.S.-source income or income that is effectively connected with the conduct of a trade or business within the U.S. Therefore, the decision to make the election depends on the income each of you makes and the sources from which it originates.

SEPARATE RETURNS

If you are married at the close of a tax year, you and your spouse may file separate returns. While it is generally more beneficial to file jointly, in some instances you may be able to reduce your overall tax liability. For example, one spouse may not want to be potentially liable for tax on a joint return and would therefore rather file separately even though the resulting tax liability may be higher.

If you and your spouse file separate returns, you should each report only

your own income, exemptions, deductions, and credits. You can file a separate return even if only one of you had income. Since you filed separately, you and your spouse are each responsible for your own taxes due on your own return.

Itemized deductions

If you and your spouse file separate returns and one of you itemized deductions, the other may not claim the standard deduction and must also itemize his or her deductions.

Miscellaneous itemized deductions. Miscellaneous itemized deductions are allowed only to the extent they exceed two percent of an individual's adjusted gross income (AGI). Therefore, if one spouse has a large amount of miscellaneous itemized deductions and a low AGI, while the other spouse has low miscellaneous itemized deductions and a high AGI, separate returns may result in a lower combined tax liability.

Remember, however, that if one spouse itemizes deductions, the standard deduction for the other spouse will be zero because both must either itemize or claim the standard deduction, even if filing separately.

> *Example.* Wendy, who is married to Bill, has AGI of $100,000 and no miscellaneous deductions. Bill has $10,000 of gross income and $2,200 miscellaneous itemized deductions. If they file a joint return, no miscellaneous deductions would be allowed; because two percent of $110,000 combined AGI is $2,200. If separate returns are filed, Bill would be allowed to deduct $2,000 of the miscellaneous itemized deductions.

Moreover, the deduction for medical expenses is allowed only to the extent the expenses exceed 10 percent of a taxpayer's AGI (7.5 percent for taxpayers over age 65). Thus, if one spouse has paid a large amount of qualifying medical expenses while the other spouse has not, it may be advantageous to file separate returns.

COMMUNITY PROPERTY

Federal taxation of community property generally follows property rights under state law. If income is community property and you and your spouse file separate returns, half of the income is reported by you and half by your spouse. If income is separate property, it is all reported by the owner-spouse.

What is community property?

Community property is all property acquired by you and your spouse during the marriage while domiciled in a community property state, other than separate property. Community property also generally includes property that you and your spouse agreed to convert from separate to community property, and property that cannot be identified as separate property.

Separate property is:

- Property acquired by a spouse before marriage;
- Property acquired during or after the marriage by gift, devise, or bequest;
- Property acquired while domiciled in a non-community property state; and
- Rents, profits, royalties, and income derived from the separate property.

Whether income from separate property is separate or community income will depend on local law, although income from community property is generally community income. Some community property states, however, are divided as to whether income from separate property is separate property or community property.

- ***Planning Tip.*** If state law allows, spouses may alter the character of property by agreement.

Community property states are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Domicile. A spouse's domicile is determined by the facts and circumstances of each case, based on the spouse's presence in a particular jurisdiction and his or her intention to remain in that place.

Whether you and your spouse have community property and community income depends on the state in which you are domiciled. However, if you and your spouse are domiciled in separate states, you need to check each state's law to determine whether you have community property and income.

Tax return. If you file a federal tax return separately from your spouse (married filing separately) you must report half of all community income and all of your separate income on your return. Again, check your local state laws to determine what is considered community property and community income, and what constitutes separate property and income.

Death and divorce. Separation or divorce may end the community property, depending on local law. The death of either spouse also separates the community property by dividing the community property between the surviving spouse and the decedent's estate. Income earned during the administration of the estate continues to be taxed as community or separate income. Both the decedent's and surviving spouse's interests in the community property receive a step-up in basis when the community is terminated based on the date of death.

FAMILY BUSINESS

When operating a family-owned business, your spouse or children may also be your employee. When handled properly, significant tax savings can result. The tax advantages of employing family members generally flow from the ability to treat them as employees. The disadvantages principally flow from the added employment tax and other liabilities that are generated.

Wages

The wages paid to your spouse (or other family member) can be deducted as a business expense, just like wages paid to any other employee. To be deductible, the payments must be reasonable and must be for services actually rendered.

> ***Caution.*** Accurate recordkeeping is essential. In addition, the work performed must be of the type that would generate "ordinary and necessary" business expenses. With these caveats in mind, business owners may be able to shift income to a spouse or other family member.

Health insurance

While your spouse (or other family member) receives taxable wages, they may also be eligible to receive employee benefits such as group health insurance. This can include coverage for all family members, including the principal owner spouse, thereby effectively converting all family health insurance premiums into business expenses.

> ***Caution.*** In addition to your regular tax liability, a tax of 15.3 percent applies to your net earnings from self-employment. The tax should play a role in deciding whether to have medical premiums and other fringe benefits written off as a trade or business deduction through a spouse-employee. Even though health insurance costs are 100 percent deductible for the self-employed, benefits remain in setting up a medical plan which is deductible as a business expense since the deduction continues to reduce, dollar for dollar, the profits on which self-employment tax is computed.

Your business can also set up a medical reimbursement plan under which

the spouse-employee is reimbursed for health insurance premiums. The spouse can also use the plan to deduct insurance co-pays, prescriptions, eye glasses, dental care, orthodontics, and other medical expenses that would otherwise be confined to an itemized deduction. In addition, an employee spouse would be entitled to $50,000 of group-term life insurance premiums and disability premiums as nontaxable fringe benefits.

Retirement plans

Marriage can affect your retirement planning in many ways, including the tax implications of your retirement plan.

Employer plans. An employer-sponsored retirement plan, such as a 401(k), 403(b), or 457 plan, requires you to name your spouse as your beneficiary under the plan. Upon your death, the plan must either be paid in full or in the form of a qualified joint and surviving annuity to your surviving spouse. You must obtain your spouse's approval to waive this requirement to name another beneficiary.

For example, if you are separated from your spouse but not divorced, the spouse will still have a legal claim to your benefits under the plan unless he or she signs a waiver. A waiver will also need to be obtained from your spouse for any loans or hardship withdrawals you want to make from the plan.

Comment. A same-sex couple is subject to the same rules if the couple is legally married in a jurisdiction that recognizes the marriage and regardless of whether the jurisdiction in which they reside recognizes same-sex marriages or not.

IRAs. For married couples, the maximum deduction for IRA contributions is calculated separately for each spouse and without regard to any community property laws.

The limit on contributions to IRAs, including Roth IRAs, for the lesser compensated member of a married couple that files jointly is calculated using a combined compensation limit. The maximum contribution that can be made to the lesser compensated spouse's IRA during the year is the lesser of the applicable dollar amount $5,500 for 2014, plus catch-up contributions if allowable, or the sum of the couple's taxable compensation reduced by amounts contributed to the higher compensated

spouse's Roth and traditional IRAs. This means contributions for a nonworking or lesser-earning spouse cannot exceed the combined earned income of the spouses.

> ***Comment.*** IRAs maintained for unemployed spouses are often called "spousal" IRAs. These IRAs are subject to the same rules as traditional IRAs, except that contributions may exceed the owner's compensation.

> ***Example.*** Carl and Sara, both ages 45, file a joint return for 2014. Carl's wages were $40,000 and their AGI is $48,000. Sara was unemployed during 2014. Carl and Sara can each contribute and deduct up to $5,500 to their IRAs for 2014.

ESTATE PLANNING

The federal estate tax imposes a maximum estate tax rate of 40 percent with a $5 million exclusion for the estates of decedents dying after December 31, 2012. The $5 million exclusion is adjusted for inflation ($5.34 million for 2014).

Marital Deduction. A major benefit of marriage under the estate tax law is the marital deduction. An unlimited estate tax marital deduction allows spouses to transfer property between themselves free of estate tax. To qualify for the estate tax marital deduction, the spouses must have a valid marriage under applicable state law at the time of the decedent's death. The marital deduction is allowed for a same-sex couple so long as the couple is legally married in a jurisdiction that recognizes the marriage regardless of whether the jurisdiction of their residence recognizes same-sex marriages.

Portability. Another benefit accorded married couples under the estate tax is the concept of "portability." Portability allows a surviving spouse to take advantage of the unused portion of the estate tax exclusion amount of his or her predeceased spouse, thus providing the surviving spouse with a larger exclusion amount. A "deceased spousal unused exclusion amount" is available to the surviving spouse only if an election is made on a decedent spouse's timely filed estate tax return (Form 706). Portability is available to the estates of decedents dying after December 31, 2010.

> ***Comment.*** Combined use of the marital deduction and portability provides estate planning flexibility for married couples.

QTIP trusts

In circumstances where it may not be desirable to leave your entire estate to your surviving spouse, a qualified terminable interest property (QTIP) trust may be used. In general, a QTIP trust allows the surviving spouse to make use of the trust property tax free.

QTIP is property that passes from the decedent to a trust in which the surviving spouse has a qualifying income

interest for life. The surviving spouse has a qualifying income interest for life if (1) the surviving spouse is entitled to all of the income from the property payable no less frequently than annually, and (2) the surviving spouse is the only one with power to appoint any part of the property to any individual.

A QTIP trust is designed to provide management and control of assets for a surviving spouse after the first spouse dies. It is designed so that all assets in the trust qualify for the unlimited marital deduction. The surviving spouse thereafter generally receives income distributions from the trust for life. Federal estate taxes are deferred until the surviving spouse dies and the trust property passes to the final trust beneficiaries, such as children. Any property that remains in the QTIP trust at the time of the surviving spouse's death is included in his or her gross estate.

Family limited partnerships

Family limited partnerships (FLPs) are a popular and effective wealth preservation, estate planning, and asset protection tool. An FLP is simply a limited partnership formed by family members. A properly structured, funded and operated FLP offers several tax and non-tax benefits, such as minimizing estate, gift and income tax liability, transferring family wealth from one generation to the next, and protecting assets from creditors.

Assets such as the family business, real estate interests, cash, marketable securities, and other assets, such as those expected to appreciate, can be contributed to the FLP tax free. In general, a senior family member will later transfer or gift their limited partnership interests to their children and/or grandchildren, although retaining a general partnership interest in order to maintain control over the FLP's assets. As limited partners, the children and/or grandchildren become owners of (nonvoting) economic interests in the FLP.

Advantages. The FLP has advantages over other asset protection tools. For example, if both spouses are at risk, such as joint filers, revocable living trusts will not protect the couple or their assets. But a limited partnership will normally shield the assets, and the couple can maintain control as general partners.

Limited partnerships also can reduce income and estate tax because the transferred interests are not charged to the donor/general partner. The independent reasons for forming a limited partnership may help establish that there is not fraudulent intent for the transfer of assets to the partnership.

Minority interest discount. A FLP allows families to take advantage of the applicable discounting of minority interests, as well as making full use of the annual $14,000 gift tax exclusion for 2014 and the lifetime gift tax exemption. Over several

decades, it can allow significant amounts to pass tax free to family members.

> ***Caution.*** FLPs continue to come under scrutiny by the IRS, which believes that many taxpayers who use these trusts try to undervalue the assets transferred to the partnerships to save estate and gift taxes. In the courts, those who set up FLPs have met with mixed results, with decisions commonly turning on whether the taxpayer has tried to grab too much from the IRS. The balancing act here is to value gifts and limited partnership interests at reasonable discounts without losing tax advantages simply out of the fear of an IRS audit.

Gift-giving

For gifts made after 2012, the gift tax is reunified with the estate tax with a top gift tax rate of 40 percent and an applicable exclusion amount of $5 million. The $5 million exclusion is adjusted for inflation ($5.34 million for 2014).

Donors of lifetime gifts continue to be able to apply the annual gift tax exclusion before having to use part of their applicable exclusion amount. For 2014, that inflation-adjusted annual exclusion amount is $14,000 per donee (married couples may continue to "split" their gift and may make combined gifts of $28,000 to each donee).

> ***Comment.*** Gifts to your spouse are not taxable.

Gift-splitting. For married couples, each spouse can make a separate gift to a third party and have the gift treated as made one-half by you and one-half by your spouse. This is referred to as gift-splitting. If both spouses agree to split the gift, each can claim up to the annual exclusion ($14,000 for 2014) for their part of the gift.

In 2014, gift-splitting allows married couples to give up to $28,000 to any one person, and to an unlimited number of individuals, without making a taxable gift.

If you split a gift you made, each spouse must sign the required gift tax return (Form 709) to show that both consented to use gift-splitting.

CONCLUSION

Marriage instantly changes your relationship with the tax law. It confers benefits and disadvantages. Its impact is felt by your spouse, children and future generations. To fully utilize the marriage tax incentives, and set-out a strategic plan, consult with your trusted tax advisor.