MARRIAGE

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MARRIAGE

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;
- Tax Rate Structure;
- Marriage Penalty;
- Community Property;
- Family Business; and
- Estate Planning.

FILING STATUS

Your filing status (married or unmarried) affects:

- Whether you file a return;
- Your standard deduction;
- The taxes you owe; and
- Whether you can claim deductions and/or credits.

The filing status you can choose depends on your marital status on the last day of your tax year.

If you are unmarried, you may choose one of the filing options:

- Single;
- Head of household; or
- Qualifying widow(er).

"Unmarried," for those who have been married, means you either obtained (1) a final decree of divorce or separate maintenance by the last day of your tax year or (2) a decree of annulment (no valid marriage existed).

If you are married, you may choose one of the filing options:

- Married filing a joint return; or
- Married filing a separate return.

> ***Caution.*** You are married if you are separated but have not obtained a final decree of divorce or separate maintenance by the last day of your tax year.

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Tax year. Marital status is determined at the close of the tax year, unless a spouse dies during the year. If either spouse dies, marital status is determined at the time of the spouse's death unless the surviving spouse remarries before the end of the tax year.

JOINT RETURNS

If you are married at the close of a tax year, you may file a joint return, or you may file separate returns.

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.

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

Citizenship

At least one of you must be a U.S. citizen or resident at the end of the tax year. If either you or your spouse is a nonresident alien and elect to file jointly, you must attach a statement to your tax 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.

HEAD OF HOUSEHOLD

Generally, you may not use head of household filing status if you are married. An individual filing as head of household is generally entitled to higher standard deduction and lower tax rate than single taxpayer. A taxpayer qualifies for head of household status if taxpayer:

- Is not married at year-end;
- Is not a surviving spouse;
- Paid more than half the cost of keeping up a home for the year; and
- Shared that home with a qualifying individual for at least half the year or can claim a dependency exemption for a parent who lived outside the home.

SEPARATE RETURNS

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 can not claim the standard deduction and must also itemize his or her deductions.

When filing separately is advantageous

It is generally more advantageous for married couples to file jointly because they will pay less income tax. Married couples usually have a lower tax liability if they file a joint return than if they file separately because of the tax rates and other provisions that are generally more generous to married individuals filing jointly.

However, filing separate returns can be beneficial in certain circumstances. 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.

Miscellaneous itemized deductions. Miscellaneous itemized deductions are allowed only to the extent they exceed 2 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 adjusted gross income (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 2 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 7.5 percent of a taxpayer's adjusted gross income. 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.

TAX RATES

Income tax rates for individuals through December 31, 2010 are at their lowest in recent history: 10%, 15%, 25%, 33%, and 35%. After 2010, they are scheduled to "revert" to 15%, 28%, 31%, 36% and 39.6%, unless Congress makes the lower rates permanent. However, the Obama administration supports reinstating the top two marginal income tax rates of 36 percent and 39.6 percent after 2010 for single individuals with incomes above $200,000 and married couples filing jointly with incomes above $250,000, while extending the lower rates.

It is almost certain that after 2010 the top two income tax brackets will increase and tax planning – whether for married couples or single taxpayers – must take into account these higher rates.

Marriage penalty relief

Prior to what is now regarded as "marriage penalty relief," newly married couples filing their first joint return often discovered a downside to married life – paying more taxes. This is the so-called "marriage penalty." Historically, the basic standard deduction for married taxpayers filing joint returns was less than twice the basic standard deduction for single taxpayers. This formula was responsible for part of the "marriage penalty."

However, in 2001 Congress began providing married joint filers relief by increasing their allowable basic standard deduction to twice that of the standard deduction for individual filers. However, relief was only intended by Congress to be temporary. Marriage penalty relief is scheduled to sunset after December 31, 2010.

Standard deduction

For married joint filers, the standard deduction amount for the 2010 tax year is $11,400, exactly double the amount for single taxpayers).

Affected taxpayers. 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.

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;

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- 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 determined 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 may also be your employee. When handled properly, significant tax savings can result.

The tax advantages of employing your spouse generally flow from the ability of the spouse to receive tax-friendly fringe benefits in his or her capacity as an employee. The disadvantages principally flow from the added employment tax and other liabilities that are generated, especially when a related person is an employee.

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

A spouse who is hired as a bona-fide employee generally can be given health insurance coverage that includes coverage for all family members, including the principal owner spouse, thereby effectively converting all family health insurance premiums into business expenses.

Self-employment tax

At 15.3 percent of earnings, the self-employment 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.

Section 105 reimbursement plans

Setting up a "section 105" medical reimbursement plan under which the spouse-as-employee is covered creates benefits in addition to a business expense deduction for health insurance premiums. The spouse can also use the plan to deduct insurance co-pays, non-covered prescriptions, eye glasses, dental care, orthodontics, and other medical expenses that would otherwise be confined to an itemized "Schedule A" deduction subject to the difficult-to-reach 7.5 percent floor. 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. For example, you can roll over your IRA to your spouse's IRA, and vice versa.

Beneficiaries. Many 401(k) plans and other retirement accounts follow conventional joint and survivor rules that generally require you to name your spouse as the beneficiary. If not, your spouse must file a waiver that you both agree in writing to choose or name another beneficiary.

Under 401(k)s and other retirement accounts that follow conventional joint-and-survivor rules, your spouse is legally entitled to a share of your retirement in the form of lifetime annuity payments. In effect, you may be required under the rules of your plan to obtain your spouse's approval for any loans or hardship withdrawals you want to make from the account.

> ***Comment.*** A surviving spouse can also generally treat your IRA as his or her IRA.

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

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.

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 ($5,000 for 2010, 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.

Contributions for a nonworking or lesser-earning spouse cannot exceed the combined earned income of the spouses.

Example. Carl and Sara, both age 45, file a joint return for 2010. Carl's wages were $40,000 and their adjusted gross income is $48,000. Sara was unemployed during 2010. Carl and Sara can each contribute and deduct up to $5,000 to their IRAs for 2010.

ESTATE PLANNING

As the law currently stands, the estate tax does not apply to decedents dying after December 31, 2009 and before January 1, 2011. However, a legislative "fix" is expected to be enacted in 2010. Congress has a nine-month window to extend the 2009 estate tax regime retroactively to January 1, 2010 before the estates of decedents dying on January 1, 2010 would be required to file estate tax returns. A bill approved by the House in early December 2009 would set the maximum estate tax rate at 45 percent and the estate tax exclusion amount at $3.5 million ($7 million for married couples). The bill would be retroactively applied to take effect for decedents dying after December 31, 2009 and before January 1, 2011.

For the time being, the estate tax in 2010 has been replaced with carryover basis at death rules. The income tax basis of property acquired from a decedent's estate generally must be carried over from the decedent. Executors may partially increase the basis of the property by up to $1.3 million ($3 million in the case of property passing to a surviving spouse).

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 (FLP) 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 (non-voting) 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 $13,000 gift tax exclusion for 2010 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 2010, the annual gift tax exclusion is $13,000. This means that you can generally give up to $13,000 per person, to any number of people, without paying gift tax.

> *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 ($13,000 for 2010) for their part of the gift.

In 2010, gift-splitting allows married couples to give up to $26,000 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.