



# Marriage

GAINER DONNELLY & DESROCHES

## Marriage

The moment you say “I do,” not only does your life change, your tax status also changes. Taxes probably aren’t on the minds of most newly married people, but marriage brings with it many tax advantages and a few disadvantages.

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.

**Caution.** Many of the traditional approaches to marriage tax issues changed dramatically with passage of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) and subsequent laws, including the *Working Families Tax Relief Act of 2004*. The New laws affect income tax rates, education savings, retirement plans, estate and gift taxes, and businesses.

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## 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 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).

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

- Married filing a joint return
- 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.

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.

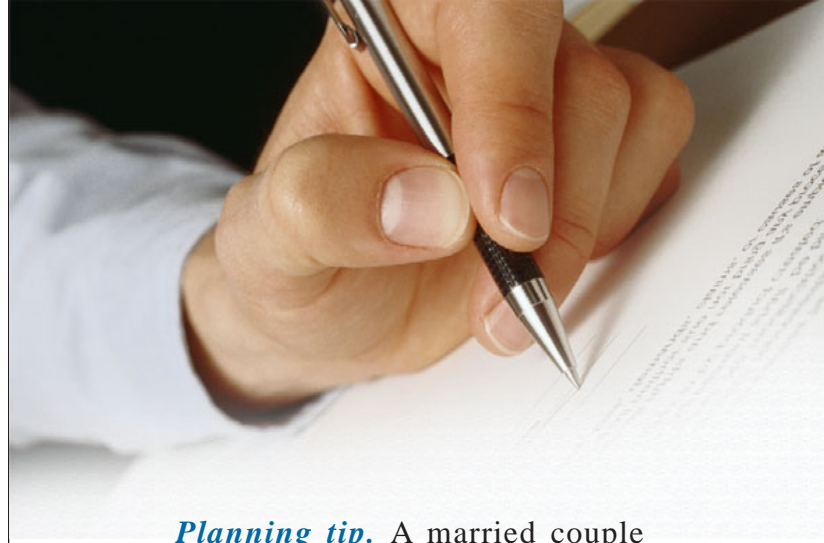
## Joint Returns

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,



**Planning tip.** A married couple usually benefits by filing jointly because a joint return, as compared with two separate returns, evenly splits income, thereby probably reducing the highest marginal tax rate to which it is subject.

- (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).

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) if those methods clearly reflect your income.

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.

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.

### **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.

### **Head of Household**

Generally, you may not use head of household filing status if you are married. However, you may file as Head of household if you meet the following conditions:

- You and your spouse have not lived in the same residence for more than six months (before July 1 if you are on a calendar tax year), not counting temporary absences due to special circumstances;
- You have a qualifying dependent; and
- You paid more than half the cost of keeping up your home.

### **Citizenship**

At least one of you must be a US 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 US income taxation only if they have US source income or income that is effectively connected with the conduct of a trade or business within the US. 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 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 will not qualify for the standard deduction and must also itemize his or her deductions.

### New Tax Rates

Tax rates for individuals from now until 2010 are at their lowest in recent history: 10%, 15%, 25%, 33% and 35%. After 2010, however,

they are scheduled to “revert” to 15%, 28%, 31%, 36% and 39.6% unless Congress makes the lower rates permanent.

A new 10 percent tax rate has been added, providing relief to all individuals. It applies to the first \$7,550 of taxable income for single filers, \$10,750 for heads of households, and \$15,100 for joint returns through 2010.

### Marriage Penalty

Married couples filing their first joint return often discover a downside to married life — paying more taxes. This is the so-called “marriage penalty.”

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 taxes by filing a joint return. The marriage penalty appeared in 1969 when Congress tried to equalize the unfair advantage couples held over single taxpayers.

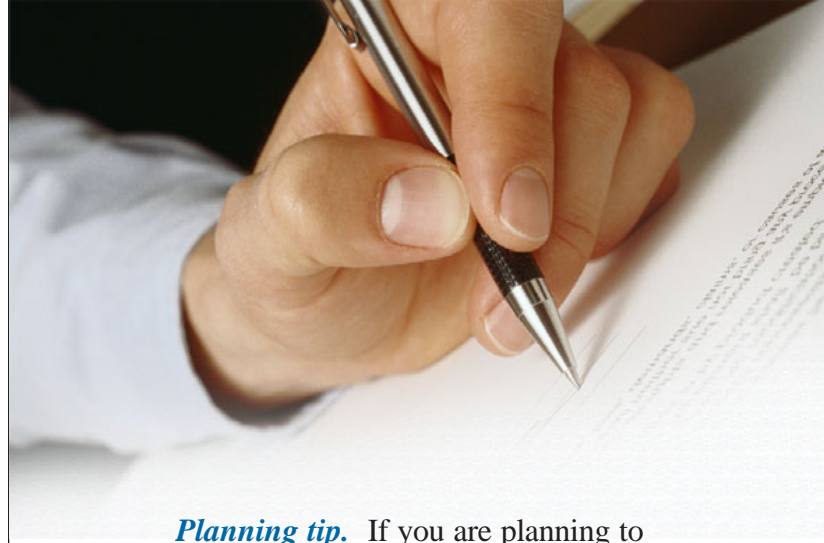
When Congress devised the standard deduction, the amounts were based on the assumption that married couples generally share expenses and therefore live less expensively than do two single individuals, even if the singles make the same amount of money. So the singles were given a more generous per-person deduction.

An additional cause of the marriage penalty relates to the taxable income level at which the tax brackets are set. For example, in 2001 single filers paid 15 percent of tax on the first \$27,050 of taxable income. Joint filers paid 15 percent on the first \$45,200 of taxable income. Taxable income above this amount (not over \$109,259) was taxed at 27.5 percent. By eliminating the penalty in the 15 percent bracket, joint filers would pay 15 percent tax on the first \$54,100 ( $\$27,050 \times 2$ ) of taxable income.

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### **Easing the penalty**

Recent legislation has increased the standard deduction that married filers can claim so that it is double that of single filers. In addition, the 15 percent tax bracket for married joint filers has expanded, meaning more of a couple's income will be taxed at this lower rate.



*Planning tip.* If you are planning to be married, remember that your marital status is determined on the last day of the year.

## **Married Filing Jointly Tax Brackets**

<b>2006 Taxable Income</b>	<b>Tax Rate</b>
\$0 — \$15,100 .....	10%
\$15,101 — \$61,300 .....	15%
\$61,301 — \$123,700 .....	25%
\$123,701 — \$188,450 .....	28%
\$188,451 — \$336,550 .....	33%
Over \$336,550 .....	35%

**Caution.** Marriage penalty relief ends on January 1, 2011. This sunset clause was added by lawmakers to ensure that all the tax changes, marriage penalty included, met federal budget limits. However, Congress may vote to make marriage penalty relief permanent after 2011.

## 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 property that is acquired while a spouse is domiciled in a community property jurisdiction and that is not separate property. Separate property is property acquired by a spouse before marriage, or during marriage by gift, devise, or bequest. Whether income from separate property is separate or community income will

depend on local law, although income from community property is generally community income.

**Practice tip.** Spouses may alter the character of property by an agreement if state law allows.

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.

### What happens upon death or 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.

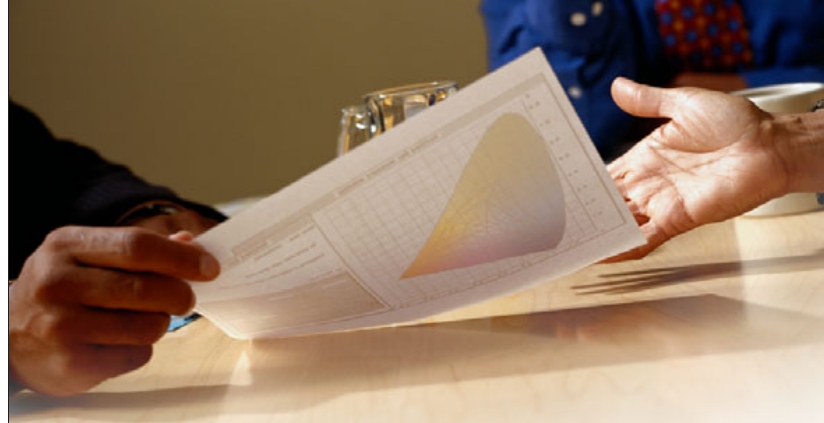
### Wages

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



**Planning tip.** Running the numbers usually reveals the continuing benefit of having a spouse as an employee covered under a health plan in which the rest of the family, including the owner-spouse, are covered as dependents. Although the wages of the spouse are subject to FICA, the spouse is able to build up Social Security and Medicare credits.

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, noncovered 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% 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**

Having a spouse count as an employee is a double-edged sword in several respects. For example, ownership attribution for tax purposes may be a problem. The basic definition of a highly compensated employee is one either earning above the threshold level or a five percent owner. As a result, a spouse who is deemed to be a highly compensated employee or even a key employee may limit a small business owner’s ability to use an age-related or cross-testing of the retirement plan.

Nevertheless, in certain instances having a spouse as an employee can help direct more retirement benefits to the owner. This apparent paradox works because of the testing rules for “highly compensated.” For example, when a spouse is on the payroll as a lower paid employee such as an office manager, choosing to exclude the spouse from participation in a retirement plan can have a positive effect on cross testing, since the percentage of highly compensated employees covered under the plan is reduced dramatically.

Because of the attribution rules, there would then be two highly compensated employees. By excluding the spouse from participation in the plan, only 50 percent of highly compensated employees are covered, thereby reducing the percentage of non-highly compensated employees that need to participate in the plan to avoid top heavy rules, or creating a favorable computation for the average benefits test.

Often small business owners will want to hire their spouses to get them onto the travel and entertainment budget more easily. Unfortunately, this will guarantee closer IRS scrutiny during any travel and entertainment audit. These expenses may be recharacterized as gifts or disguised dividends. A taxpayer may not deduct travel expenses paid or incurred for a spouse (or dependent) unless the spouse or other individual is a bona fide employee of the employer, the travel is for a legitimate business purpose, and the expenses of the spouse or other person are otherwise deductible.

## Estate Planning

The federal estate tax laws are very marriage friendly. Your spouse can inherit an unlimited amount without any federal tax consequences. However, estate planning is in a state of flux because recent tax legislation gradually reduces, and repeals, the federal estate tax. However, repeal is effective for only one year, 2010.

## Spousal deduction

The spousal deduction for estate and gift tax purposes is an unlimited deduction for property that passes to your surviving spouse. There is currently no cap.

Many wills include standard language that provide that beneficiaries other than the surviving spouse will receive an amount equal to the available estate tax exclusion. The remaining portion of the estate is given to the surviving spouse and escapes the estate tax by virtue of the marital deduction resulting in the estate tax being entirely avoided at the death of the spouse.

Automatic allocations may need to be reviewed in light of the significant increase in the estate tax exclusion (rising to \$3.5 million in 2009). An automatic provision could give heirs other than your spouse more than you intended to and, depending upon the size of your estate, unwittingly cut your spouse out altogether.

**Caution.** Although you can leave everything you own to your spouse free of federal estate tax, sometimes this tactic can actually increase estate tax costs at your spouse's death. Your tax advisor will help you plan a strategy to avert this danger.

There also are situations in which the marital deduction can be used to save tax and at the same time address non-tax concerns. For example, in some cases, leaving all the funds outright to a spouse may not be desirable. Typically, one or both spouses may be concerned about the management of the property, or may want to make sure that particular beneficiaries such as children of a prior marriage ultimately get the property.

### **QTIP trusts**

In circumstances where it may not be desirable to leave all funds to the surviving spouse, a QTIP trust may be used. While various requirements must be met to qualify as a QTIP, the most important thing is that your estate can qualify for the marital deduction without you leaving the property outright to your spouse. You only need to give the income from the property for the spouse's life.

### **Family limited partnerships**

Family limited partnerships, whether formed with a spouse, a spouse and children, or even extended family members, may be used to protect assets from creditors. They are a popular estate planning tool.

The family limited partnership 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.

A family limited partnership allows families to take advantage of the applicable discounting of minority interests, as well as making full use of the annual \$12,000 gift tax exclusion and the lifetime gift tax exemption. Over several decades, it can allow significant amounts to pass tax-free to family members.

**Caution.** Family limited partnerships have come under attack lately because the IRS 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 family limited partnerships have met with mixed results that generally turn 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.

## **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.