Implications of Life Cycle Events in Tax Preparation

Susan Kams, CPA

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Whether we like it or not, taxes dramatically impact all of our life cycle events. Understanding the tax implications during every stage of life is critical. What follows is a list of important information for you to keep in mind when you, or someone you know, experiences these changes.

1. Marriage: Getting married means an immediate change in filing status. If you get married at any time during the calendar year, your tax return for that year must be filed either as "Married Filing Joint (MFJ) " or "Married Filing Separately (MFS)." You can no longer use the "Single" filing status if you are married as of December 31 of that year. Usually MFJ is more beneficial to you than MFS. However, if one of the spouses has large medical deductions or perhaps employee business expenses and both couples have similar income, then MFS may be a better option. Keep in mind the fact that each spouse who signs a joint return is responsible for the accuracy of the return. If there are any doubts about your spouse's income or deductions, then use the MFS status.

2. Having Children: Having children has many tax benefits starting with the children being claimed as dependents on the tax return of parents that file jointly. In order to be a dependent, the child must be either under age 19 at the end of the year or a full time student who is under the age of 24 at the end of the year. The child must have the same principal residence as the taxpayer for more than half of the tax year. A taxpayer can deduct medical expenses paid for dependent children. There is also a tax credit that can be taken if both parents work and the child is in day care. Taxpayers may also be able to claim a child tax credit, but this credit phases out at higher income levels. The Kiddie Tax has to be considered if the child has any unearned income. Under the Kiddie Tax rules the unearned income of the child, above certain limits, will be taxed at the parents' tax rate.

3. College Tuition: Since college can be expensive, as children enter this phase of their life there are credits that can be taken for payment of college tuition for the taxpayer or his/her dependents. Unfortunately these credits phase out at a moderate income level. If the tuition is for a child, that child must be listed as a dependent on their parent's tax return in order for the parent to be able to take the credit. There is also a student loan interest deduction available, but that has a low phase out. In addition, a 529 plan can be used to save for college. Distributions from 529 accounts are excluded from income if used to pay for qualified higher education expenses. There is no income phase out for contributions to this

type of plan. If a grandparent pays tuition, the parent may still be able to claim the education credit.

4. Divorce: Particularly in Massachusetts, tax laws must be carefully considered when drafting a divorce agreement. Under the proper conditions, a divorced taxpayer can use the more beneficial "Head of Household" filing status. The parent that is able to take the child as a dependent may also take the dependent care credit and the child tax credit. There are specific tax rules that guide the difference between taxable alimony and nontaxable child support and the ability to deduct real estate taxes and mortgage interest on jointly-owned property. Under certain circumstances, the spouse who leaves the jointly-owned principal residence may still be able to claim the $250,000 exclusion from gain when the residence is eventually sold.

5. Retirement. Saving for retirement can be complicated because currently the options have different tax consequences. If the taxpayer is allowed to make an IRA, SEP or 401(k) contribution, there is a deduction in the year the contribution is made but it is taxable when distributions are made. Taxpayers must start taking money out of these plans when they reach age 70½. A Roth IRA contribution is not a current deduction, but will not be taxed when distributions are made. Also, distributions from a Roth IRA are voluntary and do not have to begin at age 70½. If inherited, a 401(k) plan or an IRA is taxed to the beneficiary upon receipt while a Roth IRA is inherited tax-free. The taxable portion of social security is determined by the taxpayer's income, including nontaxable interest income. The result is it can be nontaxable, 50% taxable or 85% taxable.

6. Death: There are two different types of tax returns that may need to be filed upon the death of a taxpayer. There is an estate tax return (Form 706) and an estate or trust income tax return (Form 1041). Upon death, all assets must be valued at the fair market value on the date of the death. If this amount exceeds the current exemption amount, a State and sometimes Federal Form 706 are required to be filed 9 months after the date of death. In addition, any income that the estate, or the trusts created under the will, earn before the assets are distributed to the beneficiaries must be reported on an annual form 1041 income tax return. The beneficiaries inherit most of the assets tax-free. Taxes must be paid on the receipt of certain retirement plans, annuities and US bonds. If federal estate tax was paid on these assets, there is an available estate tax deduction that can be taken on the income tax return of the beneficiary.

As you can tell, tax planning is complicated and critical to understand at every stage of life. We are here to help simplify this for you. If you have any questions, please contact any of the partners at Waldron Rand.

About the Author, Susan Kams

Susan Kams, CPA, specializes in the areas of individual, trust, estate, and divorce taxation. Prior to joining Waldron Rand in 1981, Susan worked in the education field, gaining significant experience in interpersonal communication, which she credits for her ability to successfully assist her clients through the complicated tax and financial implications associated with marriage, death, divorce, and other life cycle events.

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