FALL 2010

TAXOLUTIONS

▸▸ *ideas on taxes*

Windfalls and Your Taxes

When you receive a windfall, whether it's an inheritance from a relative, lottery or gambling winnings, or a legal settlement, you may be anxious to plan how you will spend that money. However, don't forget that taxes may be owed on the sum you received.

As soon as you learn that a significant sum of money is coming your way, consult with one of our qualified tax professionals about potential tax implications. In many cases, gifts from family members or friends, life insurance payouts, and inheritances are tax free to the recipient, although taxes may be owed by the giver or the estate from which the inheritance is received. It is also important to consider state and local taxes, which may differ from Federal rules.

Inherited Retirement Accounts

If you have inherited a traditional IRA from someone other than your spouse, you can opt to withdraw the money as a lump sum and pay all of the income taxes due in that year. Or, you can delay the tax liability by directly rolling the funds over into an inherited IRA. You will have to take required minimum distributions (RMDs) from the account and pay taxes on these withdrawals; however, you can extend RMDs based on your anticipated life expectancy.

You may also choose to transfer the IRA to another beneficiary within nine months of the account owner's death. Due to a recent change in the law, most non-spouse beneficiaries of 401(k)s and other employer-provided retirement accounts are also permitted to roll over funds into an inherited IRA.

Lottery or Gambling Winnings

Any winnings from gambling or playing the lottery are fully taxable as ordinary income, not as capital gains. If you win a lottery prize payable in installments, you are required to report on your tax return both the annual payments and any amount designated as interest on the unpaid installments. If your lottery winnings exceed $5,000, the payer will automatically withhold 25% of your winnings to cover Federal taxes—this percentage may be greater if you fail to disclose your tax identification number. In some cases, state taxes will also be withheld. In addition, you may owe estimated taxes, which must be paid quarterly. Failure to pay estimated taxes in a timely manner can result in penalties.

All gambling winnings are considered income on your Federal tax return, and the proceeds may also be subject to state taxes. If you wish to claim gambling losses on your Federal return, they must be reported separately as itemized deductions, not simply subtracted from the reported winnings. In claiming this deduction, your gambling losses may not exceed your winnings. If your

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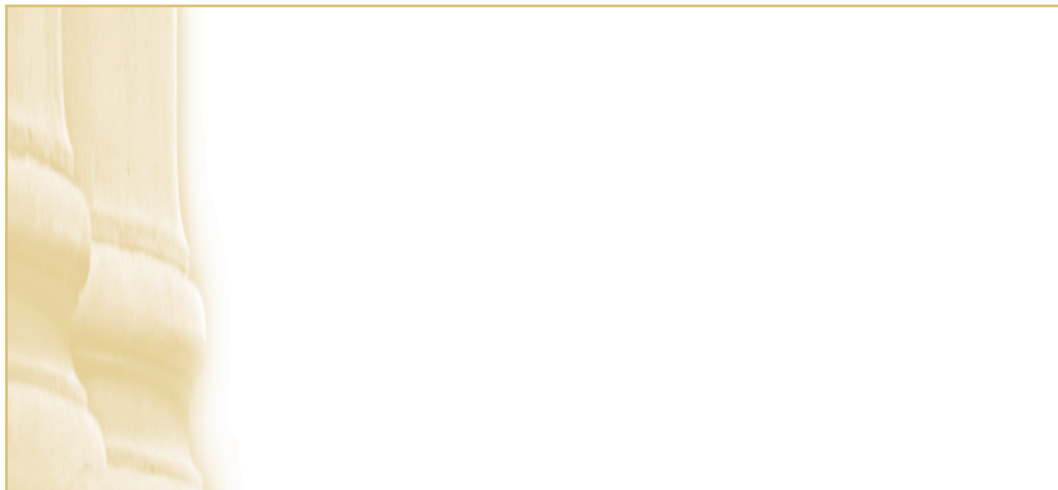

Household Employees and Your Tax Obligations

While the people you hire to perform occasional jobs, such as repairing your sink or painting your house, are independent contractors responsible for filing their own taxes, the IRS considers most adults who work in your home regularly to be your employees. Depending on the amount you pay to babysitters, housekeepers, gardeners, or cooks, and the conditions of employment, you may incur tax liabilities.

The IRS defines a household employee as someone who works under controlled conditions established by the family, including the hours worked, the location of the work, the tools and supplies used, and the responsibilities of the job. If you pay a household employee cash wages of more than $1,700 in 2010, you are likely to owe what is known as the "nanny tax." This generally requires you to withhold Social Security and Medicare, or FICA (Federal Insurance Contributions Act) taxes amounting to 7.65% of wages from all employee paychecks. Like all employers, you are then required to pay the amount withheld to the IRS, plus your matching employer contribution of 7.65%, for a total of 15.3% of the employee's wages.

If you choose not to withhold 7.65% from each paycheck, you have the option of covering the employee's share of FICA taxes with your own funds. If you do so, however, these amounts must be included in the employee's wages for income tax purposes, though they are not counted as FICA or as Federal unemployment wages.

In some cases, you may also be required to pay Federal unemployment taxes (FUTA) on the wages paid to household employees. If you pay cash wages of $1,000 or more in any calendar quarter in 2010, FUTA taxes are owed on the first $7,000 of cash wages you pay to each household employee. The tax is not withheld from the employee's wages, and must come from your own funds. While the FUTA tax is 6.2% of your employee's FUTA wages, you may be able to take a credit of up to 5.4% against the FUTA tax for any state unemployment taxes paid, resulting in a net tax of 0.8%.

These taxes are due at the end of each year, when you file a W-2 form (Wage and Tax Statement) on behalf of each employee, together with a W-3 form (Transmittal of Wage and Tax Statement). To complete these forms, you will need an employer identification number (EIN), which can be obtained by filling in Form SS-4 on the IRS website, and the Social Security numbers of each of your employees.

While you are not required to withhold Federal income tax from wages paid to household workers, you may elect to do so at the employee's request. If you do so, you must also submit a W-4 form to the IRS. If you know in advance that you will owe employment taxes for your household employees, you can elect to adjust your own W-4 form to allow for the taxes to be withheld from your own compensation throughout the year, rather than paying the full amount at the end of the year. If your household employee is a babysitter or nanny, you may be able to offset a portion of the employment taxes owed by claiming the Child or Dependent Care Credit on your Federal income tax return, or by making use of dependent care accounts provided by your employer.

These "nanny tax" rules generally apply to adults working in your house, but not to your spouse, your children under age 21, your parent (with certain exceptions), or an employee who is under age 18 at any time during the year, unless the work performed is his or her principal occupation. If you are uncertain about a worker's status, you can request a ruling from the IRS by submitting an SS-8 form (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding).

As the rules for household employees are complex, see *IRS Publication 926: Household Employer's Tax Guide* for more detailed information. And, as always, be sure to contact one of our qualified tax professionals. ■

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gambling or lottery winnings exceed specified amounts, you will receive form W-2G, Certain Gambling Winnings, from the IRS.

Legal Settlements

If you have won a lawsuit and have been awarded a legal settlement, you are likely to owe taxes, unless the damages were awarded for physical injury or illness. Most other types of damages, including settlements for personal non-physical injuries and all punitive damages, are taxed as ordinary income. To complicate matters, the percentage of the settlement that goes to your attorney in many cases also counts as your taxable income. While you are permitted to claim legal fees as an itemized deduction, this deduction could increase your alternative minimum tax (AMT) liability.

Sharing Your Windfall

If the lump sum you have received is liable to taxation, you may be able to reduce taxes by donating some of your windfall to a qualified charity. Keep in mind, however, that the deductibility of charitable gifts is limited to 50% of your adjusted gross income (AGI), although contributions that exceed these limits may be carried over for up to five years. Gifts to family and friends from your windfall will not reduce your tax liability. In fact, there may be additional gift taxes involved.

Suddenly receiving a windfall can be very exciting, but don't forget to consider your tax liabilities. For specific advice, consult one of our qualified tax professionals. ■

Strategies for Making Tax-Free Gifts to Loved Ones

If you have substantial assets, you may already be making regular tax-free gifts to your loved ones. But giving cash is only one way to transfer assets tax free to family and friends, while reducing your total assets to minimize potential estate taxes.

Each year, you are permitted to give a certain amount of cash ($13,000 or $26,000 for gifts made jointly by husband and wife in 2010) to an unlimited number of individuals without owing gift taxes on the transfer. Even with the annual limit, the total you can transfer tax free to loved ones can be substantial. For example, if you and your spouse each give the maximum tax-free amount to your son, daughter-in-law, and three grandchildren, you can transfer $130,000 to their household in a single year. You are also granted a lifetime gift tax exclusion that allows you to gift $1 million without incurring gift tax liabilities.

If some of your beneficiaries are young children, gifts may be placed in custodial accounts that are managed by the parents. Or, you could deposit gifts to grandchildren directly into a 529 plan, which is an account specifically for education expenses. With 529 plans, you are permitted to make lump-sum gifts of up to $65,000 ($130,000 for joint filers) per child, which represents five years of giving; however, you will be unable to make tax-free gifts on behalf of the same child for the next five years. The funds in these accounts have the potential to grow tax free. Distributions are also tax free, provided they are used to pay for qualified education expenses.

As an alternative, you could make direct payments to educational institutions for tuition only, and these gifts are not subject to the gift tax. Thus, you can finance the education of a loved one tax free by prepaying tuition bills. If, for example, you have selected a private school for a grandchild, you could arrange to pay the first several years of tuition in advance. To ensure that the money is not lost if the child does not attend or leaves the school, the school may agree to transfer the funds to another school under specific circumstances. When structured properly, this arrangement can save money by locking in lower tuition rates, while also making it possible to transfer funds on a tax-free basis. If you prefer not to prepay, you could send a check to the school when the tuition comes due.

If a loved one has substantial health-care expenses, you may make tax-free payments on their medical and dental bills, which may also include insurance premiums, physical therapy expenses, nursing care expenses, or the cost of modifying a home for accessibility. These contributions can be especially helpful if a loved one sustains a disability and requires ongoing care. However, for these transfers to remain tax free, payments must be made directly to the medical provider, rather than to your loved one.

Another option for transferring money to a loved one, while minimizing taxes, is to loan money, rather than gifting it outright. This strategy may be appropriate if, for example, an adult child needs a large amount of money to start a business or purchase a home. Note that if you are the lender, you are required to declare the interest income on loans exceeding $10,000 that are not paid back within the tax year. If you fail to charge interest or do not charge interest above a certain rate, the IRS could classify the transaction as a taxable gift or tax you on the interest you would have received from the loan, based on the minimum interest rate set by the IRS. However, as the lender, you also have the option of forgiving a portion of the loan each year up to the amount of the gift tax exclusion. If your child fails to repay the loan, you may be able to write off the default as a short-term capital loss on your taxes.

It pays to understand the gift tax law. Consult one of our qualified tax professionals for more information according to your unique circumstances. ■

The "Taxing Effects" of Selling Your Home

Because of the capital gains exclusion on selling a primary residence, you may find that you do not owe Federal taxes when it comes time to sell your home. But there are situations in which a seller may incur a tax liability, especially if the sale price is very high, if the house is sold soon after purchase, or if the owners are unmarried or are selling as the result of a divorce. In many of these cases, however, the amount owed to the IRS can be minimized, or offset, with some advance planning.

Generally, if you owned and lived in the house you are selling for two of the five years prior to the sale, then you are permitted to exclude from your taxable income up to $250,000 of the capital gain if you are a single filer, or $500,000 if you are a joint filer. So, even if you rented your home for a period of time before selling it, the house still qualifies as your primary residence if you lived in it for at least two of the five years preceding the sale. To qualify for the $500,000 exclusion for married couples, at least one spouse must meet the ownership requirement, and the couple must have lived in the house for two of the five years prior to the sale. You are not, however, entitled to take a

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Staying on Track with Retirement Savings: Spousal IRAs

Whether you are a stay-at-home parent or a spouse who is simply taking some time off from work, it is important to continue saving for retirement. If you do not maintain regular contributions to your retirement accounts during your prime working years, your family may run the risk of falling short of your retirement goals, or you may need to save more later in life, when investments have less time to grow. For couples, one strategy for staying on track with retirement savings is to establish a so-called "spousal IRA."

Under IRS rules, contributions to Individual Retirement Accounts (IRAs) are limited to $5,000 in 2010 (or $6,000 for those aged 50 and older). Because IRAs are, by definition, individual, they cannot be jointly owned and must be held in the name of one spouse or the other. A married couple filing jointly is generally entitled to make a full contribution to an IRA for the non-working spouse under age 70½, provided the working spouse has enough earned income to cover the amount contributed. Income eligibility requirements must also be met.

At higher income levels, eligibility to contribute to IRAs can become complicated. If the working spouse is covered by an employer-provided qualified retirement plan, such as a 401(k), eligibility to make deductible contributions to a traditional IRA for the non-working spouse is phased out at modified adjusted gross income (MAGI) between $167,000 and $177,000 in 2010. But if neither spouse is covered by a qualified retirement plan, both the non-working and the working spouse are entitled to make deductible contributions of up to $5,000 each to traditional IRAs, regardless of MAGI.

Couples who prefer to contribute after-tax dollars to their retirement accounts may want to consider a Roth IRA for the non-working spouse. However, income-based contribution limits also apply, with contribution eligibility phasing out at MAGI between $167,000 and $177,000. Keep in mind that the contribution limit of $5,000 (or $6,000 for those aged 50 and older) in 2010 applies to the total of all IRAs that a person may hold in a given tax year.

While the amount of the working spouse's income is a factor in the non-working spouse's eligibility to contribute to an IRA, it is not required that the actual funds contributed to the IRA come from the working spouse. The non-working spouse can use money from another source, such as a gift from a family member or personal savings.

For more information about spousal IRAs, refer to *IRS Publication 590*, and contact one of our qualified tax professionals.

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The "Taxing Effects" of Selling Your Home

deduction for a loss on the sale of your primary residence, nor are you permitted to claim an exclusion on the sale of a primary residence more than once every two years.

Even if you do not meet these requirements, you may still be able to claim a full or partial exclusion under certain circumstances. If, for example, you were awarded ownership of the home as part of a divorce or separation settlement, you are allowed to count the time the house was owned by your former spouse as time you owned the home in order to pass the ownership-and-use test. Similarly, if one spouse should die and the surviving spouse has not remarried prior to the date the home is sold, the surviving spouse can count the period the deceased spouse owned and used the property toward the ownership-and-use test.

Special rules apply for members of the uniformed services, foreign services, and intelligence agencies who are selling a house they did not live in for the required two years because they were on "qualified official extended duty" at a duty station at least 50 miles from their primary residence.

Finally, you may qualify for a reduced exclusion even if you do not pass all of the tests due to a change of employment, a change in health status, or other unforeseen circumstances, such as a divorce or the birth of twins or triplets. If, for example, you were a single person who lived in the home for one year before selling it, but had to move to take a job in another city, you would be entitled to claim a $125,000 exclusion on the profit of the sale.

If you sell your home at a profit that exceeds the $250,000 or $500,000 exclusion limits, you are generally required to report the excess profit as a capital gain on the 1040 Schedule D form. However, in assessing the size of your gain, you are permitted to deduct not only the tax basis of your property (which encompasses the original purchase price, plus the cost of capital improvements, minus depreciation) but also closing costs, selling costs, and the costs of decorating and repairs made within 90 days of the sale to increase the home's attractiveness to prospective buyers.

If you are preparing to sell or have recently sold your home, contact one of our qualified tax professionals to discuss any potential tax implications. ■

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