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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

June 2013

Use a QDRO to Divide Qualified Plan Assets in Divorce

When a couple divorces, it is often necessary to divide assets held in qualified retirement plan accounts [e.g., Section 401(k), profit-sharing, or pension plan accounts] to equitably divide the marital property. When your qualified plan assets are divided in divorce, a qualified domestic relations order (QDRO) is critical. A QDRO is any judgment, decree, or order that (a) creates or recognizes the existence of an alternate payee's (e.g., your former spouse's) right to some or all of the participant's (your) qualified plan benefits; (b) is made pursuant to a state domestic relations order; and (c) relates to providing child support, alimony, or marital property rights of a spouse, former spouse, child, or other dependent of the plan participant. IRAs are not qualified plans and, therefore, not subject to the QDRO rules.

Without a QDRO, distributions from your qualified retirement plan to another person are treated as paid to that person on your behalf. Thus, you are taxed on the distribution as if you had received it and then given the cash to the other person (e.g., your former spouse). In this situation, you receive no deduction for the deemed transfer to, for example, your former spouse, and the entire distribution is taxable to you in the year received. Clearly, this is the worst possible result you might expect. However, distributions under a QDRO are taxed to the recipient (e.g., your former spouse) when received by that person. The 10% early distribution penalty tax does not apply to any distribution to an alternate payee pursuant to a QDRO, regardless of the alternate payee's age when he or she receives it.

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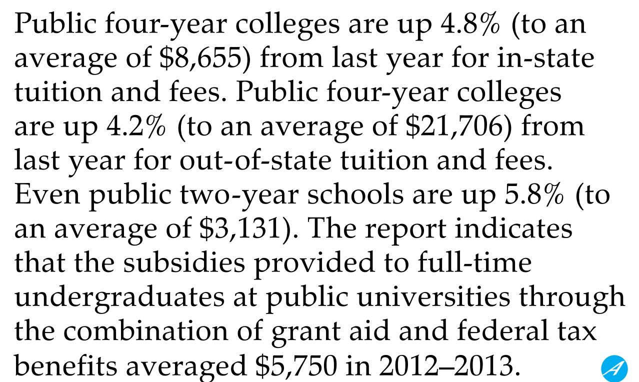
Generally, the alternate payee is assigned the participant's tax attributes under the plan. If the alternate payee is your spouse or former spouse, any distribution received by that person will qualify for rollover treatment to an IRA. A properly rolled over distribution is not taxed until it is subsequently withdrawn from the IRA. To qualify for tax deferral, the distribution must be rolled into the IRA within 60 days of receipt. The funds should be transferred directly from the distributing plan to the receiving IRA (a trustee-to-trustee transfer) to avoid the 20% withholding that is imposed if a distribution is made directly to the recipient. However, the QDRO exception to the 10% early distribution penalty tax does not apply to distributions from IRAs, SEPs, and SIMPLEs.

(Continued on Page 2.)

Higher Education Costs Continue to Escalate

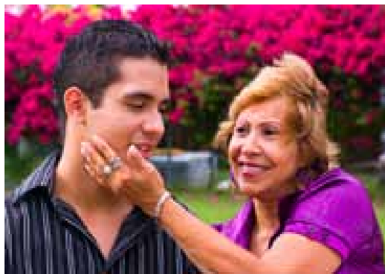
The cost of attending college continues to increase. The College Board reports that 2012–2013 tuition and fees have risen significantly **(www.collegeboard.com)**. Private four-year colleges are up 4.2% (to an average of $29,056) from 2011–2012 for tuition and fees.



Public four-year colleges are up 4.8% (to an average of $8,655) from last year for in-state tuition and fees. Public four-year colleges are up 4.2% (to an average of $21,706) from last year for out-of-state tuition and fees. Even public two-year schools are up 5.8% (to an average of $3,131). The report indicates that the subsidies provided to full-time undergraduates at public universities through the combination of grant aid and federal tax benefits averaged $5,750 in 2012–2013.

Help Grandchildren with College Costs

Contributing to a Section 529 college savings program is a great way for grandparents to help their grandchildren pay for college. It is also a great way to remove assets from the grandparent's estate without paying estate tax. As an added feature, money in a 529 plan owned by a grandparent is not assessed by the federal financial aid formula when qualifying for student aid.



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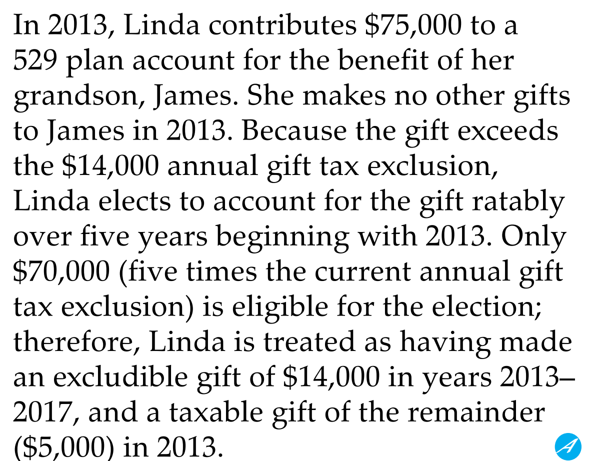
Grandparents, as well as other taxpayers, have a unique opportunity for gifting to Section 529 college savings plans by contributing up to $70,000 at one time, which currently represents five years of gifts at $14,000 per year. ($14,000 is the annual gift tax exclusion amount for 2013.) A married couple who elects gift-splitting can contribute up to double that amount ($140,000 in 2013) to a beneficiary's 529 plan account(s) with no adverse federal gift tax consequences.



Example: Electing to spread a 529 plan gift over five years.

In 2013, Linda contributes $75,000 to a 529 plan account for the benefit of her grandson, James. She makes no other gifts to James in 2013. Because the gift exceeds the $14,000 annual gift tax exclusion, Linda elects to account for the gift ratably over five years beginning with 2013. Only $70,000 (five times the current annual gift tax exclusion) is eligible for the election; therefore, Linda is treated as having made an excludible gift of $14,000 in years 2013–2017, and a taxable gift of the remainder ($5,000) in 2013.

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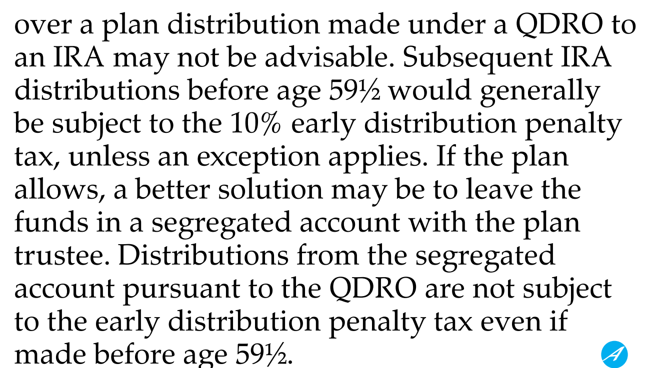
(Continued from Page 1.)

A rollover to an IRA allows the alternate payee to control the account's investment. It may also be attractive when the alternate payee wants to sever ties that connect him or her to the former spouse.

If the alternate payee is under age 59½, rolling over a plan distribution made under a QDRO to an IRA may not be advisable. Subsequent IRA distributions before age 59½ would generally be subject to the 10% early distribution penalty tax, unless an exception applies. If the plan allows, a better solution may be to leave the funds in a segregated account with the plan trustee. Distributions from the segregated account pursuant to the QDRO are not subject to the early distribution penalty tax even if made before age 59½.



Selling a Home to Your Child at a Bargain Price

As part of an estate and gift planning strategy, a taxpayer may consider transferring ownership of a family home to an adult child. Note, however, that the tax implications of such transfers can be significant. When a taxpayer sells a home (or any other asset) for a bargain price to a relative (or any other person), they are actually treated as making a two-pronged transaction. The first prong is considered a sale for an amount equal to the bargain sale price. Their entire basis (cost) in the transferred property is offset against the sale proceeds. The second prong is considered a gift equal to the difference between the fair market value (FMV) of the property and the bargain sale price. The following example illustrates the tax consequences for the seller.

> **Example**: Gwen, an unmarried taxpayer, sells her $600,000 home in 2013 to her unmarried adult son, Frank, for a bargain price of $350,000. Gwen is treated as selling the property to Frank for $350,000 and making a related $250,000 gift ($600,000 FMV – $350,000 sale price).
>
> Gwen's taxable gain from the sale prong equals the difference between the $350,000 sale price and her entire basis (cost) in the transferred property. For the gift prong, Gwen can use her $14,000 gift tax annual exclusion to reduce the potentially taxable gift amount to $236,000. The $236,000 gift then reduces her $5.25 million (in 2013) federal estate and gift tax exclusion dollar-for-dollar.

Assuming the parent has most or all of the $5.25 million federal estate and gift tax exclusion available to shelter the gift prong of the bargain sale transaction, this type of transaction generally works out quite well for the parent because it removes an appreciating asset from their estate. Also, assuming the parent lives long enough to benefit from any future increases in the federal estate and gift tax exemption, the hit to that exemption will be partially or completely restored.

The sale prong of the bargain sale transaction obviously has income tax implications for the parent. The parent's capital gain is determined by subtracting his or her entire basis in the home from the sale price. Of course, if the home is the parent's principal residence, the $250,000/$500,000 federal gain exclusion privilege will usually be available to offset some or all of the gain.

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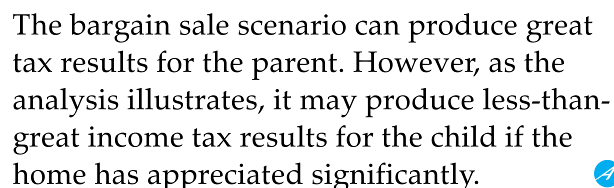
In a bargain sale scenario, the child's tax basis in the home will generally be the sale price plus the amount of any federal gift tax triggered by the transaction (if any). When the home has appreciated significantly in value (as will often be the case), the child may be stepping into a substantial built-in taxable gain that can cause future problems. This is not a great tax outcome for the child, but complaining about the tax results of an otherwise favorable bargain sale deal seems petty.

On a more positive note, if the child uses the home as a principal residence for at least two years, the federal home-sale gain exclusion privilege will become available. Also, if the child is able to arrange financing for the purchase prong of the transaction, the mortgage interest will generally be deductible as qualified residence interest.

The bargain sale scenario can produce great tax results for the parent. However, as the analysis illustrates, it may produce less-than-great income tax results for the child if the home has appreciated significantly.



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Tax Benefits for Adoption Expenses

Taxpayers with certain eligible adoption expenses can benefit at tax time by claiming either a tax credit or, if their adoption expenses are reimbursed by their employer, an income exclusion for the reimbursement. The income exclusion is only available if their employer maintains an adoption assistance program. The credit and exclusion are subject to a dollar limitation and phase-out for taxpayers whose income exceeds certain thresholds.

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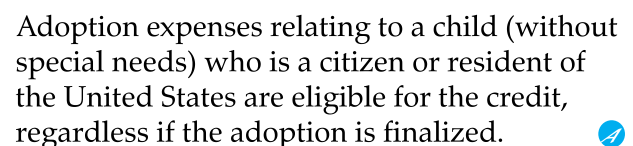
For 2013, taxpayers can claim a tax credit for up to $12,970 of qualifying adoption expenses. This is not an *annual* limitation; instead, it applies to the adoption of each child and is cumulative (for that child) over all tax years. When applying the limitation, adoption expenses incurred in an unsuccessful attempt to adopt an eligible child are included with those of the first subsequent successful adoption. The limitation is the same for both married and unmarried taxpayers, but married couples must file a joint return to claim the credit.

The credit for an adoption involving a child with special needs that becomes final in the tax year is automatically $12,970, regardless of the actual amount (even if less than $12,970) of qualifying adoption expenses incurred. For other adoptions, the limit remains as the lesser of actual qualifying adoption expenses or $12,970.



Adoption expenses relating to a child (without special needs) who is a citizen or resident of the United States are eligible for the credit, regardless if the adoption is finalized.

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