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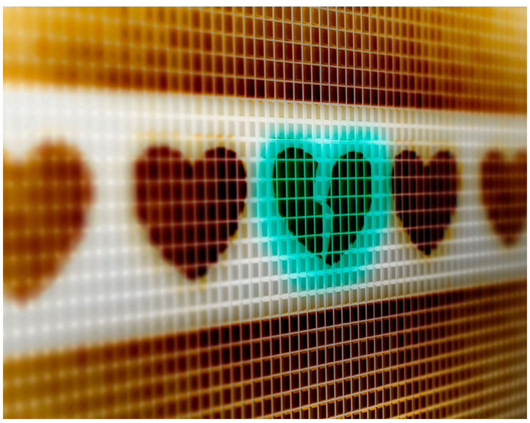
CPA
Client Bulletin
Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

May 2016

Health Insurance and Divorce



Going through a divorce can be a stressful experience, and some items may be overlooked. Nevertheless, if you are in this situation, you should be sure to pay some attention to future health insurance. Medical bills and health insurance premiums can be extremely expensive; any lapse in coverage might lead to a financial crisis.

The fine points of paying for health insurance after a divorce will vary by your specific circumstances, including the terms of current coverage and state law. That said, here are some general thoughts to help you in this area.

For covered employees

In many families, Spouse A and Spouse B are married; the health insurance is provided through a group plan from Spouse A's employer. If you are Spouse A, you should notify the appropriate person at your company when divorce proceedings are initiated. Removing Spouse B from the coverage may save you money by lowering the insurance premiums, even if you continue to carry the children on the policy.

Your spouse may ask you to continue his or her coverage but that's probably not feasible. After a divorce, your ex-spouse generally won't qualify for family coverage on your plan.

Disconnected from family coverage, Spouse B might request that you pay the premiums for ongoing health insurance, as part of the divorce negotiation. If possible, see if that amount can be included in an alimony agreement because alimony you pay will be tax deductible.

For covered spouses

On the other hand, you might be Spouse B, covered by health insurance from Spouse A's workplace. After a divorce, you likely will lose that coverage, so you won't have health insurance.

If you're employed and work for a company with a health plan, you can go onto that plan. However, without such an opportunity, your best choice might be to

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What's Inside

Plump Payouts

Shareholder returns in the form of dividends and stocks buybacks hit a record $245.7 billion in the third quarter of 2015, bringing the trailing 12-month total to a record $934.8 billion.

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rely on the Consolidated Omnibus Budget Reconciliation Act, known as COBRA.

COBRA, a federal law, requires companies with 20 or more employees to continue group health insurance to certain parties, including divorced spouses. Many states have similar laws that cover firms with fewer employees.

However, COBRA has certain drawbacks. You'll have to pay premiums calculated at 102% of the plan's cost, which probably will be much more expensive than the often-subsidized group coverage provided to employees. Beyond cost, COBRA for ex-spouses will last no more than 36 months. After that, you'll have to supply your own health insurance.

Even with these concerns, COBRA can be a worthwhile stopgap while you seek coverage of your own. To qualify, you must notify the administrator of the group plan within 60 days of being divorced. Once you're on COBRA, you can take the time to seek alternative health insurance, perhaps via the Affordable Care Act exchanges.

Seek Advice

You should retain a knowledgeable attorney to help you negotiate the terms of a divorce, and that advice should cover future health insurance—whether you are Spouse A or Spouse B. Maintaining coverage is vital. Our office can help you and your counsel work out a tax-efficient agreement. ■

Trusted Advice

Taxes and Divorce

- ❖ If you pay alimony under a divorce or separation agreement, you may be able to deduct the payments, as long as they qualify as alimony for federal tax purposes.
- ❖ Among several requirements for payments to be considered alimony, the divorce or separation agreement must require the payments be made, and there must be no liability to make any payments for any period after the recipient spouse's death.
- ❖ If you get alimony from your spouse or former spouse, you report the payments as taxable income.
- ❖ If you pay child support, those payments are not deductible.
- ❖ If you receive child support, the money you receive does not have to be reported as taxable income.

Fun and Games… and Taxes

As 2016 began, people were lining up to buy tickets for the Powerball lottery, which eventually reached a total prize of $1.58 billion. Many states have lotteries, and countless participants win prizes, albeit usually much smaller than the Powerball jackpot. Are such winnings taxable? The answer, in a word, is yes. (As an exception to this rule, some states exempt their lottery winnings from state income tax.)

According to the IRS, lotteries are a form of gambling, along with pastimes such as raffles, horse racing, and casino games. Cash winnings are taxable income, as is the fair value of prizes such as cars and trips. All of your gambling winnings must be declared on Form 1040 of your tax return as "Other Income."

Gambling winnings are taxed as ordinary income, with tax rates as high as 39.6%. Some large winnings, such as lottery payouts, can be spread over many years, which also spreads the tax bill. Taking a smaller amount in consecutive years may reduce the effective tax rate on those winnings.

How winnings are reported

Depending on the activity, gambling winnings of a certain size will be reported by the payer on Form W-2G, which is sent to you as well as to the IRS. Larger winnings are subject to withholding, generally at a 25% federal rate; state tax also may be withheld.

Example: Lois Martin wins $10,000 in her state's lottery. Of her winnings, $2,500 (25%) is withheld for the IRS while $500 (5%) is withheld for her state. Thus, Lois receives $7,000 upfront. When Lois files her tax return for the year, her $10,000 lottery income, as well as the $2,500 and $500 amounts paid in tax, will be included in calculating her federal and state income tax obligation.

Gain from losses

Suppose, in this scenario, that Lois buys $10 worth of lottery tickets every week, or $520 a year. Can she net that amount against her winnings, to reduce the tax she'll owe?

Not directly. The amount to be reported under "Other Income" is the gross amount of your gambling winnings for the year. That includes all of your winnings, not just those reported on Form W-2G. Note that this amount will be counted in your adjusted gross income (AGI), and an increased AGI may reduce your ability to use certain tax benefits elsewhere on your tax return.

In order to get any tax benefit from her $520 in lottery purchases, Lois must itemize deductions on Schedule A of her Form 1040. On this form, her lottery purchases can be included under "Other Miscellaneous Deductions." Thus, Lois will reduce her taxable income from her lottery win and trim her tax bill.

The gambling losses that Lois can report on Schedule A are not limited to lottery purchases, even if her only winnings are from a lottery. She can report all of her losses from casinos, horse races, and Super Bowl bets, and so on, up to the $10,000 she has reported as winnings. That is, the gambling losses you report on Schedule A of Form 1040 can be no greater than the gambling winnings you report.

Suppose Lois has $11,000 in gambling losses for the year. She can deduct losses up to the amount of winnings she reports: $10,000 in this example. The excess $1,000 can't be carried over to future years.

On the bright side, gambling losses aren't subject to the various limitations on some miscellaneous itemized deductions.

Loss lessons

As is the case with any tax deduction, you'll need evidence to support the amount of the gambling losses you claim, in case your return is questioned. Your best plan is to keep a detailed log of all gambling activities, showing winnings and expenses, as well as tangible items such as lottery tickets and betting slips. Moreover, you should use gambling losses as tax deductions only if the total of all your itemized deductions exceeds the standard deduction you're entitled to claim.■

New Law May Boost C Corporations

As explained in the April 2016 issue of the ***CPA Client Bulletin,*** the recently-signed Protecting Americans from Tax Hikes Act of 2015 reinstates some expired tax benefits retroactively and makes them permanent. On the list is the 100% tax exclusion of the gain from sales of qualified small business stock (QSBS).

Example 1: Nick Oliver creates a company in 2016 and sells all the stock in it in 2022 for a $3 million gain. If the stock meets the requirements to be QSBS, Nick will owe no tax on that $3 million profit. (In most cases, tax-free gains of QSBS are capped at $10 million.)

The devilish detail

A five-year holding period for the stock is required; however, the main obstacle to tax-free gains may be the structure of the business. Among other things, for the 100% exclusion to apply, the QSBS rules require the taxpayer to sell stock in a C corporation that was originally issued after September 27, 2010. Consequently, selling shares of an S corporation or membership units of a limited liability company (LLC) won't generate tax-free QSBS treatment.

With that in mind, should entrepreneurs structure their companies as C corporations? Is the lure of potential tax-free gains sufficient to choose this type of entity?

C corporation drawbacks

With a C corporation, double taxation can be an issue.

Example 2: Suppose that Nick Oliver runs his business as a C corporation; if so, the company's profits would be exposed to the corporate income tax. Then, if Nick distributes the profits to himself, he'll owe tax on those dollars at ordinary income rates. Meanwhile, Nick's company gets no deduction for the dividend payout.

Efforts to avoid this double taxation may lead to problems. Paying the profits to himself as a tax-deductible salary or bonus may bring Nick an IRS penalty for unreasonable compensation, yet retaining the

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dividends in the company might lead to the accumulated earnings tax.

With an LLC or an S corporation (assuming requirements are met), there is no corporate income tax and no need for planning around it. The company's profits are taxed once, on the owners' personal income tax returns.

What's more, many closely held companies will report operating losses, especially in the early stages of the business. S corporation and LLC owners may be able to deduct those losses on their personal tax returns, but that opportunity is not available to C corporation shareholders.

Blocked at the exit

Even if you decide to structure your company as a C corporation, and if a profitable sale of the business becomes a possibility, you still might not be able to enjoy tax-free gains. That's because QSBS treatment relies upon the sale of *stock* in the business. However, shares of stock might not change hands when a small company is acquired.

Often, a buyer will prefer to purchase the assets of a company, rather than the shares. Purchasing all of a company's assets effectively transfers ownership of the business to the buyer.

Taxes play a role in this buyer preference. After an asset purchase, the basis in those assets often can be stepped up to market value, which may provide the new owner with valuable depreciation deductions.

Perhaps more important, buying stock could result in the assumption of unknown liabilities. Environmental issues may surface in the future; claims for prior damages might be filed. Although such concerns may be addressed in a stock purchase agreement, the possibility of future exposure could cause buyers to shy away. In our example, Nick might operate a C corporation for many years, dealing with double taxation, only to eventually exit via an asset sale and lose the QSBS tax exclusion.

Reaching a decision

Generally, entrepreneurs who intend to hold onto a business for the long run, perhaps passing it on to family members, may be well served with an LLC or S corporation structure. Conversely, those who hope to attract outside investors, grow the business rapidly, and ultimately go public might prefer to run a C corporation. The possibility of tax-free gains can be another factor, tipping the scales towards a C corporation.

Specific circumstances will vary from one company to another. Our office can help you decide upon a business structure, weighing the chance that you'll one day be able to take tax-free gains on the sale of qualified small business stock. ■

Did You Know?

The percentage of workplace retirement plan participants with loans and the percentage of assets loaned have reached their lowest rates in more than a decade. Only 14.6% of participants have an outstanding loan balance; only 0.7% of all plan assets are held in loans.

Source: Plan Sponsor Council of America

TAX CALENDAR

MAY 2016

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2016. This due date applies only if you deposited the tax for the quarter in full and on time.

May 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

JUNE 2016

June 15

Individuals. If you are not paying your 2016 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2016 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2015. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 17.

Corporations. Deposit the second installment of estimated tax for 2016.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

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