TAX IMPACT

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Tax Tips

Beware of tax surprises if you work remotely

The COVID-19 pandemic forced many employees to participate in a global experiment on the pros and cons of remote work. As a result, it's here to stay for many businesses. A remote workforce offers many benefits, for employer and employees alike. But it may also lead to some tax surprises, especially if workers cross state lines.

Employees: How to avoid double taxation

It wasn't unusual, during the early days of the pandemic, for employees to work remotely from another state. Perhaps they wanted to take advantage of a vacation home during lockdown or simply wanted to get out of the city for a while. For some businesses, however, remote work has become a permanent arrangement, allowing employees to live and work further away from the brick-and-mortar office.

If you live in one state and work remotely for an employer in another state, familiarize yourself with the tax laws in both states and determine how they may affect you. For example, you may need to file income tax returns in both states, which may result in increased — or even double — taxation.

Here's the problem: States generally have the power to tax the income of people who are domiciled there as well as people who reside there. Domicile is a state of mind, and is often based on a person's intent to make a location his or her "true, fixed permanent home." Residency is based on physical presence in a state for a certain amount of time (typically, 183 days per year).

It wasn't unusual, during the early days of the pandemic, for employees to work remotely from another state.

It's possible to be domiciled in one state and a resident of another. For example, Dan has a home in State A, where his job is located, and a vacation home in State B. His employer allows employees to work remotely, so Dan now spends more than 200 days per year living and working in State B. State A considers Dan to be domiciled there, but State B views him as a resident, so he's subject to taxes in both states on the same income. He may avoid double taxation if one or both states provide credits for tax paid to other states. But his tax bill may still increase if, for example, State B's income tax rate is significantly higher than State A's rate.

One way for employees to avoid double taxation is to ensure

Can remote workers deduct their business expenses?

Generally speaking, employees can't deduct unreimbursed job-related expenses under current tax law. Prior to the Tax Cuts and Jobs Act (TCJA), employees could claim certain costs as miscellaneous itemized deductions, which are deductible to the extent they exceed 2% of adjusted gross income. But the TCJA eliminated those deductions for 2018 through 2025.

Remote workers generally aren't eligible for the home office deduction either. That deduction is generally limited to self-employed business owners. Pre-TCJA, employees could claim the deduction if, among other things, they worked at home "for the convenience of the employer." It may be difficult for remote workers to demonstrate that they're working at home for the employer's convenience. But in any event, the TCJA also eliminated that provision for 2018 through 2025.

The most tax-efficient option is for the employer to reimburse remote workers for their business expenses according to an "accountable plan" that requires employees to substantiate their expenses and meets certain other requirements. Properly reimbursed expenses are deductible by the employer and excludable from the employee's income.

that they're both residents and domiciliaries of the state from which they're working remotely. Going back to the example, if Dan sells his home in State A and takes other steps to cut ties with State A and establish roots in State B, he may avoid taxation by State A. However, this may not work if State A is one of the handful of states that have enacted "convenience of the employer" laws. Under these laws, a state can tax an out-of-state employee's income from a source within the state, if the employee works remotely for his or her own convenience, not the employer's. In other words, State A can impose its income tax on Dan by demonstrating that he's working from State B for personal reasons rather than because it's a job requirement.

Employers: Why multistate tax issues matter

From an employer's perspective, allowing employees to work remotely may create obligations to withhold and remit income and payroll taxes in several states. Plus, having employees in other states may be sufficient to establish nexus with those states, potentially triggering liability for their income, franchise, gross receipts, or sales and use tax. In addition to the expense of tax reporting in multiple states, this may increase an employer's overall tax liability.

Typically, states determine the portion of a business's income subject to their taxes based on an apportionment formula tied to the percentage of the business's sales, property and payroll attributable to that state. Most states' formulas consider either all three factors or a single sales factor. Whether apportionment increases or decreases a business's tax liability depends on whether its income is apportioned to a state with higher or lower tax rates than its home state.

Exercise remote control

If you're a remote worker or own a business that employs remote workers, be sure you understand the tax implications. In some cases, you may be able to take steps to minimize multistate tax obligations. But even if you can't, it's important to know what to expect. ■

Who are your beneficiaries?

Outdated beneficiary designations can sink your estate plan

"Nonprobate assets" are those that bypass more traditional estate planning vehicles, such as a will or revocable trust. Instead, they're transferred to family members through beneficiary designations. Nonprobate assets can include IRAs and certain employer-sponsored retirement accounts, life insurance policies, and some bank or brokerage accounts.

If you've designated beneficiaries for certain assets, it's critical to review your choices periodically. This is especially important after a major life change, such as a divorce or the birth of a child or grandchild.

Conduct your review

As you review your beneficiary designations, consider the following best practices:

Name a primary beneficiary and at least one contingent beneficiary. Without a contingent beneficiary for an asset, if the primary beneficiary dies before you — and you don't designate another beneficiary before you die — the asset will end up in your general estate and may not be distributed as you intended. In addition, certain assets offer some protection against your creditors, which would be lost if they were transferred to your estate. To ensure that you control the ultimate disposition of your wealth and protect that wealth from creditors, name both primary and contingent beneficiaries and avoid naming your estate as a beneficiary.

Update beneficiaries to reflect changing circumstances. Designating a beneficiary isn't a "set it and forget it" activity. Failure to update beneficiary designations to reflect changing circumstances creates a risk that you will inadvertently leave assets to someone you didn't intend to benefit, such as an ex-spouse.

It's also important to update your designation if the primary beneficiary dies, especially if there's no contingent beneficiary or if the contingent beneficiary is a minor. Suppose, for example, that you name your spouse as primary beneficiary of a life insurance policy and name your minor child as contingent beneficiary. If your spouse dies while your child is still a minor, it may be advisable to name a new primary beneficiary — such as a trust — to avoid the complications associated with leaving assets to a minor (court-appointed guardianship, etc.). Note that there are a lot of nuances to consider when deciding to name a trust as a beneficiary.

Consider the impact on government benefits. If a loved one — for example, a disabled child — depends on Medicaid or other government benefits, naming that person as primary beneficiary of a retirement account or other asset may render him or her ineligible for those benefits.

A better approach may be to establish a special needs trust for your loved one and name the trust as beneficiary.

Designating a beneficiary isn't a "set it and forget it" activity.

Keep an eye on tax developments. Changing tax laws can easily derail your estate plan if you fail to update your plan accordingly. For instance, the SECURE Act, enacted in 2019, sounded the death knell for the "stretch" IRA.

Previously, when you left an IRA to a child or other beneficiary (either outright or in a specially designed trust), distributions could be stretched over the beneficiary's life expectancy, maximizing tax-deferred savings. But the SECURE Act requires most nonspousal beneficiaries of IRAs to distribute the funds within 10 years after the owner's death. In light of this change, you should review the designated beneficiaries for your IRAs and other retirement accounts.

Align your estate planning goals

No matter how carefully you plan your estate, your objectives can easily be thwarted by inappropriate beneficiary designations for nonprobate assets. Avoid unintended consequences by reviewing your beneficiary designations regularly to make sure they're still appropriate and that they align with your overall estate planning goals. Contact your estate planning advisor to help you determine if you need to make any changes to your current estate plan. ■

How to minimize tax on Social Security benefits

There's a common misconception that Social Security benefits are tax-free. In fact, many people pay federal tax on a portion of their benefits.

Recent inflation has resulted in a record 8.7% cost-of-living adjustment to Social Security benefits for 2023. But the tax brackets used to determine how much of your benefits are taxable aren't adjusted for inflation. This means that some Social Security recipients will see their tax bills increase this year. The good news is that there are strategies available to minimize these taxes. But first, let's discuss how Social Security benefits are taxed.

Federal taxation of benefits

The portion of your benefits that's taxable depends on your combined, or "provisional," income. It's equal to your adjusted gross income (AGI) from sources other than Social Security, plus any nontaxable interest you receive, plus one-half of your Social Security benefits. Thus:

- If your combined income is less than $25,000 ($32,000 for joint filers), then your Social Security benefits aren't taxable.
- If your combined income is between $25,000 and $34,000 ($32,000 and $44,000 for joint filers), then up to 50% of your benefits are taxable.
- If your combined income is more than $34,000 ($44,000 for joint filers), then up to 85% of your benefits are taxable.

Suppose, for example, that Carol is a retiree who files her federal tax return as an individual and that her annual Social Security benefits total $36,000. If her AGI is $30,000 (and assuming she receives no nontaxable interest), then her combined income is $48,000 ($30,000 plus one half of $36,000). That means up to 85% of her Social Security benefits, or $30,600, is taxable.

Tips to ease the tax bite

The key to reducing tax on Social Security benefits is minimizing your combined income. One way is to put off claiming Social Security for as long as possible — until age 70 — which also maximizes the amount of your benefits.

During your 60s, consider taking withdrawals from IRAs or other tax-deferred accounts, spreading them out to minimize the tax hit in any given year. That way, by the time you reach your 70s, you'll have reduced your balances in tax-deferred accounts, thereby reducing your required minimum distributions and, in turn, your combined income.

Another strategy is to use a Roth IRA to save for retirement, or to convert traditional IRAs into Roth IRAs before you start taking Social Security benefits. Qualified withdrawals from Roth IRAs are tax-free and don't count toward your combined income. Keep in mind that a Roth conversion will trigger immediate taxation of the converted amount, so it's usually best to do the conversion gradually over several years to spread out the tax and avoid pushing yourself into a higher tax bracket.

Important: Most states don't tax Social Security benefits, but some do. If you live in one of these states, consider the impact of state taxes as part of your planning efforts.

Have a plan

If you're approaching retirement, consider the taxability of Social Security benefits. With some planning, you can minimize, or even avoid, those taxes. Your financial advisor can explain your options. ■

Charitable deductions: Dot the i's and cross the t's

Don't underestimate the importance of the substantiation requirements for deductions of charitable gifts. In a recent U.S. Tax Court case, a taxpayer lost nearly $500,000 in deductions because she failed to obtain a satisfactory contemporaneous written acknowledgement (CWA) of her gift. The taxpayer donated 120 items from her collection of Native American artifacts and jewelry to a local museum. On the day the donation was made, the taxpayer and the museum executed a "deed of gift" describing the donated items and the terms of the gift.

Donations greater than $250 require a CWA that includes the amount of cash and a description of any property other than 1) the cash contributed, 2) whether the recipient provided goods or services in consideration for any such property, and 3) a description and good faith estimate of the value of any goods or services. In this case, because the deed didn't specify whether the museum provided the taxpayer with any goods or services, the deductions were denied. ■

When turning down an inheritance makes sense

Turning down "free money" may seem counterintuitive, but in some cases, it makes sense to reject (or "disclaim") an inheritance. It could reduce your family's overall tax liability to pass to someone else property that generates taxable income or would trigger gift or estate tax. For example, let's say that you inherit an IRA from one of your parents and that your child is the contingent beneficiary. Given your high tax bracket, distributions from the IRA will generate significant income taxes. If you were to disclaim the inheritance, however, it would pass to your child who, presumably, is in a lower tax bracket. ■

Is student loan forgiveness taxable?

If you or a family member was fortunate enough to have a student loan forgiven, will the amount forgiven be taxable? Generally speaking, forgiven debt constitutes taxable income. However, forgiven student debt is currently exempt from federal tax through 2025. In addition, most states exempt student debt relief from their income tax, but there are some exceptions.

According to a recent analysis by the Tax Foundation, forgiven student debt *may be taxable* in Arkansas, California, Indiana, Minnesota, Mississippi, North Carolina and Wisconsin. However, state rules on this issue are in flux, so check on recent developments in your state. ■

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