How Does Marriage, Owning a Home, or Parenthood Impact My Taxes?

Milestone moments such as getting married, buying a home, or having children can change the way you file your taxes as much as they can change your life. But it's important to know all the implications of making a change so you don't run into trouble like this week's listener did. Gretchen thought she was making all the right decisions by filing separately from her husband–then was slapped with penalties from the government. For advice on filing taxes after several major life events, host Stefanie O'Connell Rodriguez turns to Kristin Myers, editor-in-chief of The Balance, and Caleb Silver, editor-in-chief of Investopedia.

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Gretchen: I thought I did it correctly. I looked it up and I thought I did the research, and I didn't read this one tiny paragraph in a 30-page booklet.

Stefanie O'Connell Rodriguez: This is Taxes in Ten, a limited series from the podcast *Money Confidential* at Real Simple. I'm your host, Stefanie O'Connell Rodriguez. And this week, we're talking to a 41-year-old Minneapolis-based listener working in higher education who we're calling Gretchen–not her real name.

[MUSIC FADE UNDER & OUT]

Stefanie O'Connell Rodriguez: Back when Gretchen started her career, her then boyfriend, now ex-husband, encouraged her to start contributing to a Roth IRA, a tax-advantaged individual retirement account.

Gretchen: I had done that for about a year. And then we got married.

Stefanie O’Connell Rodriguez: After getting married, Gretchen and her husband decided to file their taxes separately.

Gretchen: My ex-husband had about six figures of student loan debt from his graduate school degree.

Stefanie O’Connell Rodriguez: Because he worked for the government, Gretchen’s husband was enrolled in the public service loan forgiveness program, which forgives the remaining student loan balance of qualifying borrowers after 10 years of payments.

Gretchen: And with that program you have to be on an income-based repayment plan. And so, if you file jointly, both of your incomes are taken into consideration when calculating the monthly payment for that plan.

Stefanie O’Connell Rodriguez: So, come tax time, they chose “married filing separately” as their tax filing status. In the meantime, Gretchen continued to save for retirement in the Roth IRA she’d started before getting married.

Gretchen: When I used the tax filing software the next year, nothing alerted me, and so I kept contributing for another year and, once again, we filed separately in the next tax year.

Stefanie O’Connell Rodriguez: But this time, while inputting all her information, her tax filing software alerted her that she had actually been ineligible to contribute to her Roth IRA.

Gretchen: And my heart sank because I didn't know much about taxes and I had never made a mistake like that before, and I didn't know how to fix it.

Stefanie O’Connell Rodriguez: What Gretchen hadn’t realized is that while the income limits for individuals who are eligible to contribute to a Roth IRA is $140,000 for single filers and $208,000 for married couples filing jointly, at least in tax year 2021, for married couples filing separately, the income limit is just $10,000.

Gretchen: Which pretty much eliminates anybody who is married filing separately from contributing to a Roth IRA. So, I had two years of over contributions that I had to fix.

Stefanie O’Connell Rodriguez: Gretchen had to withdraw the contributions she’d made, pay a penalty for every year she’d made contributions when she was not eligible

to, and pay an additional penalty for withdrawing the funds from her Roth IRA, before retirement age.

Gretchen: I still have this piece of paper, even though this was 12 years ago—because I just am so worried that I still did something wrong with it—but I have a piece of paper where I was handwriting every contribution I made, how many shares of the index fund I had purchased, what the earnings were on that, because you have to withdraw the contributions and the earnings.

And I had done this for two years. And so, trying to figure out how to do all of that was really, really stressful. And then being hit with all the different penalties, it felt like I was trying to do the right thing and saving for retirement early. And then I was just getting hit with penalties because again I just didn't know that there was such a different income limit.

Even after I got divorced, I was a little hesitant to contribute to a Roth again for a little bit even though I was single and well under the income limits, because I think I was scared of doing something wrong again.

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Stefanie O’Connell Rodriguez: Milestone moments such as getting married, buying a home, or having children can change the way you file your taxes as much as they can change your life. So, this week, we’re back with Kristin Myers of The Balance and Caleb Silver of Investopedia to walk us through how major life milestones can impact our bottom line, especially come tax time.

[MUSIC FADE OUT]

Kristin Myers: The IRS website is really great at providing a lot of resources and tools and will answer the questions: Hey, I got married in September, can I file jointly now for the following year? The answer is yes. Or I got married February 15th, can I file jointly on my taxes this coming April? The answer is no. So, if you got married, congratulations, not just because of your nuptials, but also because you get a tax break. The tax code in the United States is not kind to the single folks out there.

Stefanie O’Connell Rodriguez: Is there an instance in which you might be married but you choose to file separately?

Kristin Myers: Yes. This is just one example that I know from a friend going through it: They got separated and they technically are legally still married, but they don't pay bills together anymore and they are now filing separately for the first time.

Caleb Silver: Another reason you might want to consider filing separately is that if one of you comes to the relationship with a lot of money or a heavy income and already has some tax burdens associated with that. You may not want to extend that to your partner when you get married. So, there are a couple of scenarios where it might make sense. You just have to really do that cost-benefit analysis to see if it does make a real difference, or if you're just over-complicating things.

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Stefanie O'Connell Rodriguez: After the break, we'll be back to break down more milestone moments and what that means for us come tax time—starting with buying a home.

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Kristin Myers: If you're buying a house to live in as your primary residence, there are some tax breaks that you can get on your federal taxes because of the taxes that you've paid on a more local level. So that's your property tax and the deductions have changed. That's called the SALT tax. And there is a cap on that now of up to $10,000. Mortgage interest can also be deducted, PMI, things that you're paying in regards to your property can also get you back some of those tax breaks. So, it is a happy, happy occasion to be able to purchase your home and it also can be happy for you come tax time as well.

Stefanie O'Connell Rodriguez: Is there something that changes with my taxes after I sold a home?

Kristin Myers: Depending on how big the gains were and if you were married or if you are single, if the house you sold was an investment property, if that house you sold was actually your primary residence. Again, taxes can be incredibly complicated. That is just to say that if you sold your house, there is definitely the potential that you could owe money on it.

Caleb Silver: The first $250,000 per person on the profit is tax-free. So, they don't take taxes unless it's above that number.

Stefanie O’Connell Rodriguez: Another major milestone I know a lot of folks are dealing with is kids. What changes?

Kristin Myers: Well, Stefanie, according to those commercials, everything changes when you have a child and that is also true when it comes to your taxes. So, the first thing that you're going to want to do as soon as your little boy or girl is born is claim them as a dependent. And that's something that you can start claiming immediately. You have something called your W4 form, which details how much money your employer should withhold from you and send off to the government—and having a child helps change that number. There's also the child tax credit that you can also potentially claim. And you can, and this is a really big one, start saving for your child tax-free for their college in a 529 savings plan.

Stefanie O’Connell Rodriguez: Caleb, tell us a little bit more about that.

Caleb Silver: The 529 college savings plan is a taxed advantage savings account that earns tax-free interest when distributions are used to pay for your child's educational expenses. Used to be just for college, but now you can use some of that money for private school tuition for grades K through 12. You don't have to actually use it on your own kid. It could be a nephew, it could be a niece, it could be a grandkid. So a 529 plan is really one of the smartest ways to save and invest that money that you're saving for them in mutual funds or in other funds that are gonna grow over time through compounding.

Believe it or not there are actually a couple of tax breaks for parents sending their kids to college and one of them is the American opportunity tax credit. The other's the lifetime learning credit. Those offset your tax bill dollar for dollar compared to just a standard tax deduction.

So, let me tell you about the American opportunity tax credit, it's based on a hundred percent of the first $2,000 of qualifying college expenses and 25% of the next $2,000. So, the maximum possible credit there, $2,500 per student in 2021. You can claim that tax credit for up to 2,500 bucks if your student is in their first four years of college, not grad school, just college here, and your income doesn't exceed $160,000 for married couples, or, if you're a single taxpayer, $80,000.

The lifetime learning credit, that can be as much as $2,000 per tax return based on 20% of up to $10,000 of higher education expenses. And that could be an unlimited amount of years, even after your kid’s out of college. Again, it has the income threshold, $180,000 for married couples filing a joint return, or $90,000 for single taxpayers. But

every little bit helps when you're paying to send kids to school and I'm facing that myself.

Stefanie O'Connell Rodriguez: Now, is there a certain cutoff point in which I can no longer claim this child as my dependent?

Caleb Silver: To claim your child as a dependent, your child must meet either the qualifying child test or the qualifying relative test. The qualifying child test means that your child must be younger than you and either younger than 19 years old or be a student younger than 24 years old at the end of the calendar year. There is no age limit if your child is permanently and totally disabled or meets the qualifying relative test.

Kristin Myers: They don't even have to be your children, let's be clear. You can claim your parents as a dependent as well. As long as, in the eyes of the IRS, this person is not someone that is paying taxes on their own, they're earning less than a certain amount, and they essentially are being sponsored by you for their care. And so, this could be someone who has some sort of illness or disease that unfortunately means that they cannot live on their own and they are your dependent for the rest of their lives or your lives—they can be claimed on your taxes. And in the case of your elderly parents, that is also true.

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Stefanie O'Connell Rodriguez: Now, claiming an elderly relative has some different rules and restrictions, depending on whether the person is your blood relative, if they live in your house or they don't; the IRS kind of details all of those different circumstances but that is definitely something that is possible.

[BEAT DROPS]

Stefanie O'Connell Rodriguez: We'll be back to take on more milestone moments and how they can change our taxes in addition to the rest of our lives, next week on Taxes in Ten, including divorce, retirement and moving across state lines.

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