PREZIOSI NICHOLSON & ASSOCIATES, CPAS

1101 Wheaton Avenue, Suite 100 Millville, NJ 08332 (856) 794-8400 Fax (856) 794-8411

TAX AND BUSINESS Alert™

September 2013

Partial Restoration of Lost Social Security Benefits

Many people are aware that if they begin receiving social security retirement benefits prior to reaching their full benefit retirement age, their benefits will be reduced when their income exceeds a certain threshold ($15,120 in 2013). However, they may not know those lost benefits are partially restored upon reaching full retirement age. This is known as the *adjustment to the reduction factor*

A few reminders to consider: first of all, remember the full retirement age is gradually increasing from 65 to 67 It's 66 for those born between 1943 and 1954. Second, every $2 of earnings in excess of the threshold ($15,120 in 2013) can cause social security benefits to be reduced by $1. Third, keep in mind there is no earnings threshold once you reach your full retirement age. However, there is a different threshold for the year you actually reach that age.

Here's how the partial restoration of lost benefits from excess earnings works. When you reach full retirement age, your benefit amount is recomputed so that the reduced early retirement benefit no longer includes the months when benefits were withheld for excess earnings.

Example: Partially restored benefits.

Sam begins receiving social security benefits at age 62 in January 2013. His reduced benefit is $800 a month ($9,600 for the year). He earns $23,120 ($8,000 over the $15,120 limit) in 2013. His benefits will be reduced by $4,000 (50% of $8,000), but he still receives $5,600 of his $9,600 in benefits for 2013 ($9,600 – $4,000 = $5,600).

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He continues to work and earns $8,000 more than the limit for the next three years. The Social Security Administration (SSA) withholds benefits for five months each year due to excess earnings ($4,000 reduction divided by $800 per month in benefits).

In January 2017, benefits are no longer reduced because Sam has reached his full retirement age. At that point, he will have received about $22,400 in benefits.

The SSA recomputes Sam's reduced benefit amount to leave out the 20 months (five months each year) when benefits were withheld. Essentially, Sam's reduced benefit is no longer based on his retiring at age 62.

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Business Tax Breaks

Several favorable business tax provisions have a limited term life that may dictate taking action between now and year-end. They include the following two provisions.

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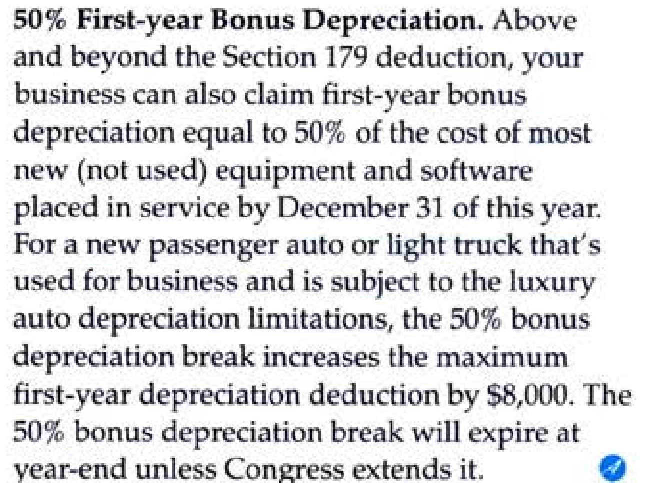
Section 179 Deduction. Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment, software, and eligible real property costs. For tax years beginning in 2013, the maximum Section 179 deduction is $500,000, including up to $250,000


for qualifying real property costs. However, you cannot claim a Section 179 write-off that would create or increase an overall business tax loss. For tax years beginning in 2014, the maximum deduction is scheduled to drop back to only $25,000, and most real property costs will be ineligible.

50% First-year Bonus Depreciation. Above and beyond the Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, the 50% bonus depreciation break increases the maximum first-year depreciation deduction by $8,000. The 50% bonus depreciation break will expire at year-end unless Congress extends it.

Partial Restoration of Lost Social Security Benefits

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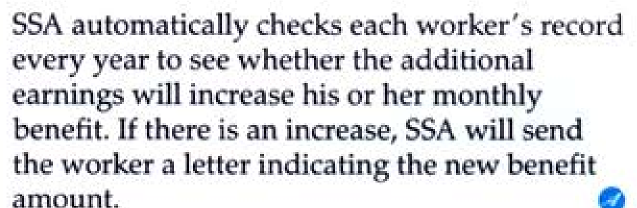
It is now based on his retiring at age 63 and 8 months (62 years plus 20 months). As a result, Sam's $800 monthly benefit amount increases to about $900. (If he had waited until full retirement age to start receiving benefits, the monthly benefit amount would have been about $1,067.)


Note: This example is based on estimates. It also does not include cost-of-living increases or earnings added to the worker's record after benefits started.

SSA automatically checks each worker's record every year to see whether the additional earnings will increase his or her monthly benefit. If there is an increase, SSA will send the worker a letter indicating the new benefit amount.

The 3.8% Net Investment Income Tax—More Than Meets the Eye

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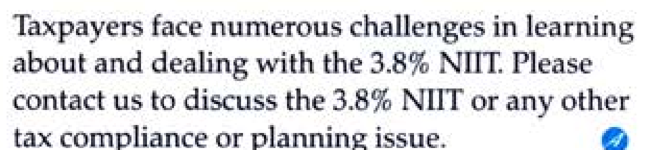
For business owners, a gain or loss from the disposition of an interest in a partnership or S corporation may be subject to the 3.8% NIIT. However, a complex calculation involving a deemed sale analysis may be required to make this determination.

Finally, a taxpayer may be subject to both the 3.8% NIIT and the additional 0.9% Medicare tax, but not on the same income. The additional 0.9% Medicare tax applies to wages and self-employment income over certain thresholds, but it does not apply to items included in investment income. So, taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes.

Taxpayers face numerous challenges in learning about and dealing with the 3.8% NIIT. Please contact us to discuss the 3.8% NIIT or any other tax compliance or planning issue.



The 3.8% Net Investment Income Tax—More Than Meets the Eye

There's a lot for taxpayers to know when it comes to the 3.8% net investment income tax (3.8% NIIT). This new tax is imposed on income from several sources and its impact is far reaching. Analyzing its impact can get complicated fast.

Originating as a component of 2010 health care legislation and first effective in 2013, the 3.8% NIIT is assessed on the lesser of net investment income (NII) or modified adjusted gross income (MAGI) above specific thresholds. MAGI is adjusted gross income plus any excluded net foreign earned income. The MAGI thresholds are $200,000 for single individuals, $250,000 for joint filers and surviving spouses, and $125,000 for married taxpayers filing separate returns.

Only individuals with some amount of NII, and MAGI above the applicable threshold amount, will be subject to the 3.8% NIIT. For example, if a married couple has $200,000 of wage income and $100,000 of interest and dividend income (i.e., MAGI totaling $300,000), the 3.8% NIIT applies to the $50,000 that is over the $250,000 MAGI threshold.

Trusts and estates can also be hit with the 3.8% NIIT. But for them, the tax applies to the lesser of their undistributed net investment income or AGI in excess of the threshold for the top trust federal income tax bracket. For 2013, that threshold is only $11,950, so many trusts and estates will no doubt be affected this year.

The components of NII generally include gross income from interest, dividends, royalties, and rents; gross income from a trade or business involving passive activities; and net gain from the disposition of property (other than property held in a trade or business in which the owner materially participates). All of these components are reduced by any allocable deductions. This may sound simple, but as always, the devil is in the details.

On a positive note, NII does not include tax-exempt bond interest, veterans' and social security benefits, excluded gain from the sale of a principal residence, life insurance proceeds received by reason of an insured's death, lottery winnings, and the tax-free inside buildup of the cash surrender value of life insurance, among other items.

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Fortunately, distributions from retirement plans are generally not included in NII. However, if included in MAGI, qualified plan distributions may push the taxpayer over the threshold that would cause other types of investment income to be subject to the 3.8% NIIT.

Another positive aspect of the 3.8% NIIT is that it does not apply to income from a trade or business conducted by a sole proprietor, partnership, or S corporation; but income, gain, or loss on working capital is not treated as derived from a trade or business and thus is subject to the tax. The term *working capital* generally refers to capital set aside for use in, or the future needs of, a trade or business.

Unfortunately, the 3.8% NIIT does apply to income derived from a trade or business if it is a passive activity or a trade or business of trading in financial instruments or commodities.

With regard to property dispositions, a gain from the disposition of property that is considered held in the ordinary course of a trade or business is generally exempt from the 3.8% NIIT. Despite the preceding exception, gains from dispositions of property held in a passive business activity or in the business of trading in financial instruments or commodities (whether passive or not) are included in the definition of NII.

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PREZIOSI NICHOLSON & ASSOC
1101 WHEATON AVE
STE 100
MILLVILLE, NJ 08332-2003

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Alert
September 2013

Is My Gift Taxable?

Taxpayers are often confused about when a gift is taxable or nontaxable. We thought it would be a good time to review some basic information on the annual gift tax exclusion.

Most gifts are not subject to the gift tax. For example, there is usually no tax when you make a gift to your spouse or a charity. If you make a gift to someone else, the gift tax usually does not apply until the cumulative value of the gifts you give to that person during the year exceeds the annual gift tax exclusion. In 2013, the annual federal gift tax exclusion amount is $14,000. A federal gift tax return generally only has to be filed if you give someone (other than your spouse or a qualifying charity) money or property worth more than the exclusion amount.

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If federal gift tax is due, it typically will be paid by the person making the gift. The person receiving the gift does not pay federal gift tax or federal income tax on the value of the gift received. However, other than gifts that are deductible charitable contributions, the person making the gift will not be able to deduct the value of the gift on his or her federal tax return.

Thus far, we have indicated that gifts (a) for less than the annual exclusion during the calendar year, (b) made to your spouse, or (c) made to a qualifying charity, generally are not subject to the federal gift tax. In addition to these provisions, tuition or medical expenses you pay directly to an educational or medical institution for someone else are not subject to federal gift tax, either. However, you cannot first give the money to an individual for the purpose of paying the end recipient. To avoid federal gift tax liability, the money must be paid directly to the institution.