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Tax and Business Alert™

May 2013

Tax Breaks for Families and Students

Recent legislation made permanent or extended several tax breaks for families. In addition, several education breaks were made permanent or extended.

Child Credit. For 2013 and beyond, the maximum credit for an eligible under-age-17 child (Child Credit) was scheduled to drop from $1,000 to only $500. The legislation permanently installs the $1,000 maximum credit.

Adoption Expenses. The Bush tax cut package included a major liberalization of the adoption tax credit and also established tax-free employer adoption assistance payments. These taxpayer-friendly provisions were scheduled to expire at the end of 2012. The credit would have been halved and limited to only special needs children. Tax-free adoption assistance payments from employers would have disappeared. The legislation permanently extends the more-favorable Bush-era rules.

Education Credit. The American Opportunity Credit, worth up to $2,500, can be claimed for up to four years of undergraduate education and is 40% refundable. It was scheduled to expire at the end of 2012. The legislation extends the American Opportunity Credit through 2017.

College Tuition Deduction. This write-off, which can be as much as $4,000 at lower income levels and as much as $2,000 at higher income levels, expired at the end of 2011. The legislation retroactively restores the deduction for 2012 and extends it through 2013.

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Student Loan Interest Deduction. The student loan interest write-off can be as much as $2,500 (whether the taxpayer itemizes or not). Less favorable rules were scheduled to kick in for 2013 and beyond. The legislation permanently extends the more favorable rules that have applied in recent years.

Coverdell Education Savings Accounts. For 2013 and beyond, the maximum contribution to federal-income-tax-free Coverdell college savings accounts was scheduled to drop from $2,000 to only $500, and a stricter phase-out rule would have limited contributions by many married filing joint couples. The legislation makes permanent the favorable rules that have applied in recent years.

Increased Medicare Payroll Tax

The Medicare payroll tax is the primary source of financing for Medicare, which generally pays medical bills for individuals who are 65 or older or disabled. Wages paid through December 31, 2012, were subject to a 2.9% Medicare payroll tax. Workers and employers pay 1.45% each. Self-employed individuals pay both halves of the tax, but are allowed to deduct the employer-equivalent portion (i.e., 1.45%) for income tax purposes. Unlike the social security payroll tax, which applies to earnings up to an annual ceiling ($113,700 for 2013), the Medicare tax is levied on all of an employee's wages subject to FICA taxes.

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Beginning in 2013, individuals who have wage and/or self-employment income exceeding $200,000 ($250,000 if married, filing a joint return; $125,000 if married, filing separately) are subject to an additional 0.9% Medicare tax (i.e., 2.35% total) on their earned income exceeding the applicable threshold. The employer portion of the Medicare tax is not increased. However, employers are required to withhold and remit the additional tax for any employee to whom it pays over $200,000. Companies are not responsible for determining whether a worker's combined income with his or her spouse makes the employee subject to the additional tax. Therefore, many individuals (especially those who are married with each earning less than $200,000, but earning more than $250,000 combined) should adjust their federal income tax withholding (FITW) by submitting a new Form W-4 to the employer or make quarterly estimated tax payments to be sure they are not hit with an underpayment penalty when filing their income tax return each year.

Self-employed individuals who pay both halves of the Medicare tax (i.e., 2.9%) will pay a total Medicare tax of 3.8% on earnings above the thresholds. The additional 0.9% tax is not deductible for income tax purposes. Self-employed individuals should adjust their quarterly estimated income tax payments to account for this additional tax.

Married couples with combined incomes approaching $250,000 should keep tabs on their total earnings to avoid an unexpected tax bill when filing their individual income tax return. At this time, the threshold amounts ($200,000/$250,000) are not adjusted for inflation. Therefore, it is likely that increasingly more people will be subject to the higher payroll taxes in coming years.

Nonspouse IRA Beneficiaries

(Continued from Page 4.)

inherited IRA into a specially titled receiving IRA that is still in the deceased account owner's name (e.g., First Bank, Custodian for Jack Jones, Deceased, Jane Smith, Beneficiary). This does not count as a rollover for purposes of the no-rollover-allowed rule. The receiving IRA must be a brand-new IRA set up for the specific purpose of receiving the inherited IRA. It cannot be combined with other IRAs. When the inherited IRA is a traditional IRA, the receiving IRA must be a traditional IRA. When the inherited IRA is a Roth IRA, the receiving IRA must be a Roth IRA. Required Minimum Distributions (RMDs) will generally need to be made over the beneficiary's life expectancy starting the year after the IRA owner's death.

By taking advantage of this favorable rule, the balance in an inherited IRA with a sole beneficiary, who is a nonspouse, can be transferred tax-free into a receiving IRA controlled by the beneficiary. Similarly, an IRA with several nonspousal beneficiaries can be transferred tax-free into several receiving IRAs, one for each beneficiary. Thus, each beneficiary can pursue his or her own investment strategy with the inherited money.

Qualified Plan Distributions Exempt from the NIIT

Beginning in 2013, a new 3.8% Net Investment Income Tax (NIIT) applies to the *net investment income* (NII) of high-income taxpayers. The tax is levied on single individuals with a modified adjusted gross income (MAGI) above $200,000 and on joint filers with MAGI over $250,000. The $250,000 threshold also applies to a surviving spouse. Married individuals who file a separate return have a $125,000 threshold. (MAGI is adjusted gross income plus any excluded net foreign earned income.) The amounts are not indexed for inflation.

NII generally includes 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), reduced by deductions properly allocable to such income. The new tax applies to the lesser of total NII or MAGI over the applicable threshold. For example, if a couple has $200,000 of wage income and $100,000 of interest and dividend income (i.e., MAGI totaling $300,000), the NIIT applies to the $50,000 that is over the $250,000 MAGI threshold.

Distributions from the following types of retirement plans are not included in NII:

a. Qualified pension, profit-sharing, and stock bonus plans.
b. 403(a) annuity plans.
c. 403(b) annuities for employees of tax-exempt organizations or public schools.
d. IRAs and Roth IRAs.
e. 457(b) deferred compensation plans of state and local governments and tax-exempt organizations.

Example: IRA distribution exempt from NIIT.
Linda, a single taxpayer, has 2013 MAGI of $223,000, including interest of $3,350 and a taxable distribution of $26,000 from her IRA. Her income subject to the NIIT of $197,000 ($223,000 – $26,000) is under the $200,000 threshold. Therefore, Linda does not owe NIIT for 2013. However, the IRA distribution will be subject to ordinary income taxation and any penalty for early distribution (applicable, unless an exception applies).


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Observation: 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 NIIT.

An individual with investable funds who is not contributing the maximum permissible amount to a 401(k) plan or IRA should consider doing so rather than investing the difference in a regular investment account. Not only will the individual get the income tax advantages of the qualified plan or IRA for the additional contributed amounts but, in the future, he or she may save some NIIT that could have been triggered had the funds been invested in a regular investment account.

Finally, the NIIT makes Roth IRAs more attractive. Qualified distributions from Roth IRAs are tax-free and thus will neither be subject to the NIIT nor be included in MAGI for purposes of that tax. Distributions from regular IRAs (except to the extent of after-tax contributions) will be included in MAGI, although they will not be subject to the NIIT.

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Nonspouse IRA Beneficiaries

It is increasingly common for individuals to inherit IRAs. By inheriting an IRA, we mean that you become entitled to some or all of the balance in a deceased account owner's traditional IRA or Roth IRA by virtue of being designated as an account beneficiary.

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In this scenario, you may think your share of the inherited IRA balance can be distributed to you and then rolled over tax-free into your own IRA before the familiar 60-day deadline for rollovers has passed. While this seems like a reasonable assumption, it is wrong—unless you are the deceased IRA owner's surviving spouse. In other words, only a surviving spouse is allowed to roll over a distribution from an inherited IRA into his or her own IRA. Nobody else can.

Fortunately, there are ways to finesse the "no-rollover-allowed rule" so that you can take control of your share of an inherited IRA without adverse tax consequences. However, to make this strategy work, you must follow some important rules, one of which is that you cannot receive a distribution check payable to you personally from the inherited IRA. If you do so and you are not the deceased IRA owner's surviving spouse, you cannot put the money back into an IRA and continue earning tax-deferred income (or tax-free income, in the case of an inherited Roth IRA). Furthermore, if you are not the deceased IRA owner's surviving spouse, you must include it in your taxable income. Depending on the circumstances, a distribution from a Roth IRA may result in taxable income as well.

A nonspouse beneficiary can, however, make a direct (trustee-to-trustee) transfer of an

(Continued on Page 2.)