Tax and Business Alert™

March 2012

How Working Impacts Social Security Benefits

Many taxpayers are applying for social security retirement benefits earlier than they previously planned to supplement their income. But, continuing to work while receiving social security benefits may cause the benefit to be reduced below the anticipated amount. If you are a social security beneficiary under the full retirement age (currently 66), an earnings test determines whether your social security retirement benefits will be reduced because you earned more from a job or business than an annual exempt amount (discussed below). A different earnings test applies for individuals entitled to disability benefits.

As a general rule, the earnings test is based on income earned during the year as a whole, without regard to the amount you earned each month. However, in the first year, benefits you receive are not reduced for any month in which you earn less than one-twelfth of the annual exempt amount.

The social security retirement earnings test is eliminated after you reach your full benefit retirement age for the month of, and months after, such attainment. In other words, once you reach your full benefit retirement age, there is no longer an earnings test to reduce your social security retirement benefits. However, the earnings test still applies for the years and months before the month you reach the full benefit retirement age.

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Social security beneficiaries under the full benefit retirement age who have earnings in excess of the annual exempt amount are subject to a $1 reduction in benefits for each $2 earned over the exempt amount (currently $14,640) for each year before the year during which they reach the full benefit retirement age (see the example). However, in the year beneficiaries reach their full benefit retirement age, earnings above a different annual exempt amount ($38,880 in 2012) are subject to a $1 reduction in benefits for each $3 earned over the exempt amount. Social security benefits are not affected by earned income beginning with the month the beneficiary reaches full benefit retirement age.

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The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

Standard Mileage Rates for 2012

The 2012 standard mileage rates for use of an automobile are 55.5 cents per mile for business miles (the same rate in effect for the last half of 2011), 23 cents per mile for medical or moving purposes, and 14 cents per mile for rendering gratuitous services to a charitable organization.

A taxpayer may not use the business standard mileage rate for any vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System (MACRS) or claiming a Section 179 deduction for that vehicle, or for more than four vehicles used simultaneously.

Tax Planning Following a Job Loss

Taxpayers dealing with a layoff or termination frequently overlook the tax consequences of events associated with their unexpected job loss. Yet, properly handling the tax aspects of this life-changing event could prevent a negative financial impact.

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Severance or dismissal pay, including an amount paid in lieu of a termination notice, is taxable income regardless of whether the employer is legally bound to make the payment. However, the value of job placement assistance provided by an employer to a terminated or laid-off employee generally may be excluded from income as a working condition fringe benefit.

Qualified moving expense reimbursements are excluded from income. This includes any amount received, directly or indirectly, from an employer as a payment for, or a reimbursement of, expenses that would have been deductible as moving expenses on the taxpayer's personal tax return if directly paid or incurred by him or her.

Finally, distributions from a qualified retirement plan (less any nondeductible employee contributions) are generally taxed as ordinary income. A 10% penalty tax applies to distributions before age 59½, unless they are part of a series of substantially equal payments or received due to separation from service after age 55, or due to death, disability, or other specific exception.

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Example: Applying the annual earnings test.

Edward, age 62, currently averages $2,000 per month in commissions ($24,000 per year). He has recently experienced a decrease in his income due to lower sales and is considering applying for social security benefits to supplement his reduced income. Edward's social security retirement benefit will be $1,400 per month, so he expects to receive benefits totaling $16,800 per year. However, since he will earn $9,360 over the $14,640 exempt amount ($24,000 – $14,640), his benefits will initially be reduced by half that amount, or $4,680. Therefore, he will receive only $12,120 in social security benefits ($16,800 – $4,680). The results would be the same if Edward was self-employed, rather than an employee.

As you plan your retirement, be mindful that, as the previous example indicates, working during retirement and prior to your full retirement age may reduce your anticipated social security benefits. This, in turn, could have a negative impact on your overall financial plans.

Reporting Foreign Financial Assets

New regulations designed to uncover information on foreign assets owned by U.S. taxpayers have been implemented by the IRS. Where taxpayers have an interest in one or more *specified foreign financial assets* (explained below) exceeding certain threshold amounts, additional information must be included in their tax return. This required information includes, but is not limited to, the name and address of the financial institution, stock or financial instrument issuer, or foreign entity; account numbers; asset values; status of the account (open or closed); acquisition and disposal dates; and foreign currency rates.

For taxpayers living in the United States, the thresholds are assets that have an aggregate fair market value (FMV) exceeding either $50,000 on the last day of the tax year or $75,000 at any time during the tax year or $100,000 and $150,000, respectively, for married taxpayers filing a joint annual return. Higher threshold amounts apply for U.S. taxpayers living abroad.

Specified foreign financial assets are depository or custodial accounts at foreign financial institutions, and, to the extent not held in an account at a financial institution, include (a) stocks or securities issued by foreign persons, (b) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (c) any interest in a foreign entity.

In general, a taxpayer has an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected by the taxpayer on an annual return. However, to comply with the reporting requirements, a taxpayer has an interest in a specified foreign financial asset even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the holding or disposition of the specified foreign financial asset for the tax year.

Example 1: Reporting requirement for an unmarried individual.


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Brenda is not married and does not live abroad. She sold her only specified foreign financial asset prior to year-end when its value was $125,000. Brenda has to provide information on the asset since she satisfies the reporting threshold. Even though she does not hold any specified foreign financial assets on the last day of the tax year, she did own specified foreign financial assets of more than $75,000 during the tax year.

Example 2: Reporting requirement for joint filers.

Mark and Julie file a joint income tax return and do not live abroad. They jointly own a single specified foreign financial asset valued at $60,000. They do not have to provide information on the asset since they do not meet the reporting threshold for married taxpayers filing jointly of more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.

A taxpayer who fails to provide the required information is subject to significant penalties. Please call us to discuss the significance of this new reporting requirement or any other tax compliance or planning issue.

Employing Children in an Unincorporated Business

This tax-saving idea could help certain taxpayers reduce their federal taxes.

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If you operate a business as a sole proprietorship, a single-member LLC treated as a sole proprietorship for tax purposes, a husband-wife partnership, or a husband-wife LLC treated as a partnership for tax purposes, consider hiring your under-age-18 child, either full-time or part-time, as a legitimate employee of your business.

Your under-age-18 child's wages are exempt from Social Security, Medicare, and federal unemployment taxes. In addition, your child can use his or her standard deduction to shelter up to $5,950 of 2012 wages from federal income tax. Under this arrangement, your child will probably owe little or no federal income tax on the first $5,950 of wages. He or she can set aside some or all of the wages and invest the money. Hopefully, the cash stash will eventually be used to help pay for college, which means less stress for you.

Meanwhile, as the employer, you can deduct the wages paid to your child as a business expense, as long as they are reasonable for the work performed. The write-off will cut your income tax liability and your self-employment tax bill (if applicable). The write-off will also lower your adjusted gross income, which will decrease the odds of getting hit with the unfavorable phase-out rules that can reduce or eliminate various tax breaks.

After your child reaches age 18, Social Security and Medicare taxes will kick in; however, federal unemployment tax will not apply until age 21. The child's standard deduction will still shelter up to $5,950 (for 2012) from federal income tax. And, you can still deduct the wages and related employment taxes as business expenses.

Even if your business is incorporated, hiring your child can still make tax-saving sense. In this scenario, the child's wages are subject to Social Security, Medicare, and federal unemployment taxes regardless of his or her age. The good news is the child's standard deduction still provides an income tax shelter for the child, and the corporation can claim business deductions for the wages and the employer's share of the employment taxes.

Please contact us if you have questions or want more information about this strategy.