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Tax Planning E-Newsletter

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Current Planning to Avoid the Future Health Care 3.8% "Surtax"

A new 3.8% surtax on certain investment income starts January 1, 2013, as part of the health care reform act. While that's a couple of years away, it is not too early to start planning for it, because there are steps clients can take this year that will help reduce or even eliminate it.

In this issue of the *Tax E-Newsletter*, we present an overview of this surtax, explore what taxpayers it will affect, and give some planning ideas you can use now with your clients.

Understanding the Tax

The 3.8% investment income surtax, also called the health care surtax or the Medicare tax, applies to tax years ending after December 31, 2012. The surtax is:

For individuals, 3.8% of the lesser of:

1. net investment income for such taxable year, or
2. the excess, if any, of
    a. the modified adjusted gross income for the year, over
    b. the threshold amount.

For trusts and estates, 3.8% of the lesser of:

1. the undistributed net investment income for the year, or
2. the excess, if any, of
    a. the adjusted gross income (as defined in Code Section 67(e)) for the year, over
    b. the dollar amount at which the highest tax bracket in Code Section 1(e) begins for the year ($11,200 in 2010).

Three Key Numbers

There are three numbers that determine how this surtax will affect a client.

1. Net Investment Income

This is the sum of gross investment income over allocable investment expenses. For purposes of this surtax, investment income includes interest, dividends, capital gains, annuities, rents, royalties and passive activity income.

Investment income does not include active trade and/or business income; any of the income sources listed above (e.g., interest, dividends, capital gains, etc.) to the extent it is derived in active trade and/or business; distributions from IRAs and other qualified retirement plans; or any income taken into account for self-employment tax purposes.

For the sale of an active interest in a partnership or S-corporation, gain is included as investment income only to the extent net gain that would be recognized if all of the partnership/S-corporation interests were at fair market value.

2. Modified Adjusted Gross Income (MAGI)
Here, MAGI is the sum of adjusted gross income (the number from the last line on page 1 of Form 1040) plus the net foreign income exclusion amount.

3. Threshold Amount
Married taxpayers filing jointly . . . $250,000
Married taxpayers filing separately . . . $125,000
All other individual taxpayers . . . $200,000
Trusts and estates . . . Beginning of the top bracket ($11,200 for 2010)

Who Will Pay the New Surtax?
Here's a quick formula to determine if the 3.8% surtax will apply:

1. MAGI less than or equal to threshold amount = No tax
2. MAGI greater than threshold amount = Tax is 3.8% of *the lesser of*
    a. investment income or
    b. MAGI - threshold amount

Note that the surtax liability is determined on income BEFORE any tax deductions (page 2 of Form 1040) are considered. As a consequence, a client with lots of deductions could be in the lowest tax bracket and yet have investment income that is subject to the surtax!

Also, because the capital gain rate will increase for high-income taxpayers to 20% in 2011, with the 3.8% surtax the total tax on capital gains can be 23.8% in 2013 and beyond.

Let's look at some examples:

Individuals
Example: Evan, single, has $100,000 of salary and $50,000 of net investment income.
Result: The 3.8% surtax would not apply because MAGI is less than $200,000.

Example: Jill, single, has $225,000 of net investment income and no other income.
Result: The 3.8% surtax would apply to $25,000 of income (excess of $225,000 MAGI over $200,000 threshold amount).

Example: George and Eve, married filing jointly, have $300,000 of salaries and no other income.
Result: The 3.8% surtax would not apply (no investment income).

Example: Frank and Lily, married filing jointly, have $400,000 of salaries and $50,000 of net investment income.
Result: The 3.8% surtax would apply to $50,000 of net investment income (lesser of rule).

Estates and Trusts
Example: The Pat Jones Trust has investment income of $51,000 and no distributions.
Result: $39,800 of income ($51,000 - $11,200 top bracket amount) will be subject to the 3.8% surtax.

Example: The Estate of Sue Jones earned $111,200 of dividends and made no distributions.
Result: $100,000 ($111,200 - $11,200 top bracket amount) will be subject to the 3.8% surtax.

Example: The Estate of Jim Jones earned $111,200 of interest and distributes 100% of income.
Result: The income will be reported by the heirs. That income will go into their

individual surtax determinations, but the Jim Jones Estate will pay no 3.8% surtax.

Planning Tip: Start adjusting trust and estate investments now to reduce income in 2013 and beyond.

Planning Considerations

For taxpayers who could be hit by the surtax, look for ways to reduce investment income and MAGI:

* The 3.8% surtax does not directly apply to distributions from IRAs and other qualified retirement plans, and contributions to these plans provide tax-deferred growth. Therefore, taxpayers may wish to increase contributions to IRAs and 401(k), 403(b) and 457 plans. However, required minimum distributions will increase MAGI as they are considered ordinary income.

* The 3.8% surtax does not apply to distributions from Roth IRAs, but Roth conversion income will count toward MAGI. Thus 2010-2012 Roth conversions can help to avoid the surtax by reducing post-2012 MAGI from required minimum and other plan distributions in 2013 and beyond.

* Because income from tax-exempt and tax-deferred vehicles like municipal bonds, tax-deferred nonqualified annuities, life insurance and nonqualified deferred compensation are not included in investment income, investments in these vehicles should become more favorable.

* Charitable remainder trusts should become more appealing because they permit taxpayers to defer income over a period of time, enabling them to stay under the threshold amount.

* Charitable lead trusts will become more popular to shift investment income to a CLT which in turn will be offset by the "above the line" charitable deduction.

* Installment sales will be popular to smooth income.

* Oil and gas (with up to 95% initial investment deduction, 15% depletion allowance and IDC deduction on passive oil and gas) will continue to be attractive investments.

* For eligible estates and electing trusts, select the proper year to reduce the surtax.
Example: Frieda dies in January 2012. Her estate elects a November 30, 2012 year end.
Result: The surtax will not apply to her estate until the year beginning December 1, 2013, providing 11 additional months without the surtax.

Roth IRA Conversions Today Reduce Future MAGI

As stated earlier, required minimum distributions from Traditional IRAs are exempt from the surtax but they increase MAGI. This can effectively create a 43.4% effective tax on IRA distributions (39.6% income tax plus 3.8% surtax on investment income made surtaxable by the IRA distribution).

Planning Tip: Converting to a Roth prior to 2013 can reduce MAGI in 2013 and beyond and thereby reduce or eliminate surtax exposure.

Example: Robert and Anna, age 69, have pension income of $130,000 and net investment income of $115,000 for a total MAGI of $245,000, just below the threshold amount. In 2013, their RMDs from their IRAs will be $50,000, which will bring their MAGI to $295,000.
Result: MAGI is $45,000 above the threshold amount ($295,000 less $250,000) so the surtax will be imposed on $45,000 of their net investment income. Making Roth conversions in 2010, 2011 and 2012 to eliminate the RMD in 2013 would eliminate the surtax.

Planning Tip: Using outside/taxable funds to pay the income tax on a Roth conversion can be advantageous in lowering future MAGI.

Example: In 2010, Paul converts a $1 million IRA to a Roth IRA, incurring $450,000 of state and federal income tax. Paul pays the income taxes from his outside/taxable investment funds.
Result: Future investment income from the outside funds will no longer exist and will avoid the 3.8% surtax. Distributions from the Roth IRA are neither investment income nor included in MAGI.

Planning Tip: Anyone can now convert to a Roth IRA, regardless of income. If the conversion occurs in 2010, half of the conversion amount can be claimed as income in 2011 and half in 2012. After 2010, conversions must be claimed as income for the year in which the conversion is made.

Conclusion

Even though the 3.8% health care surtax will not go into effect until 2013, taxpayers who will be exposed to it should begin planning in 2010, especially if a Roth conversion is desirable. Now is the time to get organized and run the projections so you will be able to incorporate any changes in year-end planning for your clients.

Commentary regarding the estate tax exemption for 2011

It is looking more and more like the exemption will be $1 million in 2011. However, there is still a possibility that it will be $3.5 million. It is recommended that you start assessing your clients now to see which ones will be over the $3.5 million exemption and start their planning now. You can also start a "second-tier list" of those who will have net estates of between $1 million and $3.5 million so that, in the event the exemption is $1 million, you will already know which of your clients will need additional planning.

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