

#### Steve Leimberg's Income Tax Planning Email Newsletter - Archive Message #28

Date: 30-Jul-12

From: Steve Leimberg's Income Tax Planning Newsletter

Subject: **Bob Keebler & Understanding the 3.8% Medicare Surtax** 

"For tax years beginning after 2012, new Internal Revenue Code (IRC) section 1411 imposes a 3.8 percent surtax on certain passive investment income of individuals and of trusts and estates based on a mathematical formula. For taxpayers to be able to plan around the tax they must first understand what income it applies to and how the tax is calculated."

Now, **Bob Keebler** provides members with a detailed analysis of the 3.8% Medicare surtax.

**Robert S. Keebler, CPA, MST, AEP** (Distinguished) is a partner with **Keebler & Associates, LLP** and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels. He has been named by CPA Magazine as one of the Top 100 Most Influential Practitioners in the United States and one of the Top 40 Tax Advisors to Know During a Recession. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and in estate, gift and income tax examinations and appeals, and he has received more than 150 favorable private letter rulings including several key rulings of "first impression". He is the author of over 100 articles and columns and is the editor, author or coauthor of many books and treatises on wealth transfer and taxation. For information about Bob's tapes, seminars on tape, or speaking engagements, please contact Bonnie Lamirande at Bonnie.Lamirande@keeblerandassociates.com

Members shouldn't miss out on the chance to register for **Bob Keebler's** "Learn It Live" seminars being held in Milwaukee August 20<sup>th</sup> and August 21st and again in Chicago on August 22nd and 23rd. Bob describes them as a "Private Two Day Seminar for Lawyers, CPAs, and Financial Advisors Covering what the Lawyer, CPA, and Financial Advisor Need to Know About Sophisticated Planning and Drafting for IRA &

Qualified Plan Distributions, Including How to Plan with a \$5,000,000 Exemption." The cost for this private two-day seminar is \$995, but register by August 10th to receive a \$295 discount! For Information about the seminar or material, please call 920.593.1705 or email emily.rosenberg@keeblerandassociates.com

Now, here is Bob's commentary:

## **EXECUTIVE SUMMARY:**

For tax years beginning after 2012, new Internal Revenue Code (IRC) section 1411 imposes a 3.8 percent surtax on certain passive investment income of individuals and of trusts and estates based on a mathematical formula. For taxpayers to be able to plan around the tax they must first understand what income it applies to and how the tax is calculated.

# **COMMENT:**

## **Application of Surtax to Individuals**

For individuals, the amount subject to the tax is the lesser of (1) net investment income (NII) or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount. Let's first define each component of the formula.

#### **Net Investment Income**

This is investment income reduced by any deductions properly allocable to such income. For purposes of the surtax, investment income includes:

- Dividends
- Rents
- Interest
- Capital Gains

- Royalties
- Passive activity income

The types of income that is excluded from net investment income are:

- Self-employment income
- Active trade or business income
- Gain on the sale of an active interest in partnership or S-Corp
- IRA or qualified plan distributions
- Trusts for charity (except CLTs)
- Non-resident aliens

The active trade or business exclusion means that dividends, rents, interest, capital gains, annuities and royalties are not treated as NII to the extent they are derived from an active trade or business. Thus, if a taxpayer is not engaged in a passive activity business, NII includes only non-business income from dividends, rents, interest, capital gains, annuities and royalties. No business income is included. If the taxpayer is engaged in a passive activity business, however, NII includes all the items listed above plus income from the passive activity.

The charitable trust exception applies to charitable remainder trusts exempt from tax under IRC section 664, trusts exempt from tax under IRC section 501(c) and trusts in which all of the unexpired interests are devoted to charity, but not to charitable lead trusts.

#### **MAGI**

This is simply the amount reported at the bottom of page 1 of Form 1040 (AGI) plus the net amount excluded as foreign earned income under IRC section 911(a)(1). Since the foreign earned income exclusion applies only to U.S. citizens or residents who live abroad, MAGI and AGI will almost always be the same. MAGI is basically total taxable income and does not include tax-exempt income such as interest on tax-

exempt bonds, excluded gain on the sale of the principal residence or veteran's benefits. Required minimum distributions from a traditional IRA or 401(k) plan and income recognized on a Roth IRA conversion are included in MAGI, but non-taxable distributions from a Roth IRA are not.

Note that the surtax doesn't necessarily apply only to taxpayers with large amounts of taxable income. Because the calculation is based on MAGI, which is above-the line income on Form 1040, taxpayers with more modest amounts of taxable income could be affected if they have large below-the-line deductions on Schedule A. Finally, do not confuse the definition of MAGI used here with the definition of MAGI used to determine how much of an individual's contribution to a traditional IRA is deductible. Although the IRS gave the two amounts the same name, the calculations are very different.

#### **Threshold Amounts**

The applicable threshold amounts for individuals vary depending on filing status and are shown below:

Married Taxpayers, Filing Jointly	\$250,000
Married Taxpayers, Filing Separately	\$125,000
All other individual taxpayers	\$200,000

# **Application of the Surtax to Trusts and Estates**

The annual surtax payable by a trust or estate is 3.8 percent of the lesser of (1) undistributed net investment income or (2) the excess of AGI over the amount at which the top income tax bracket for trusts and estates begins. The highest bracket starts at \$11,200 for 2010, but will be indexed for inflation.

The surtax presumably will not apply to grantor trusts or to simple trusts. With a grantor trust, the grantor is treated as the owner and all items of trust income are reported on the grantor's individual tax return. Thus, the

trust's items of income would be added to the grantor's items of income and any surtax would be calculated on the grantor's return. Simple trusts require all income to be distributed currently so undistributed net investment income would ordinarily be zero.

## **Planning for the Surtax**

Before examining specific strategies for reducing or eliminating the surtax payable, some general observations may be helpful. First, assuming a taxpayer is subject to the surtax in the first place, reducing NII will always reduce the amount of surtax payable dollar for dollar. The reason is that any reduction in NII also reduces MAGI.

Example 1: Kay, a single taxpayer, has \$190,000 of salary income and \$75,000 of capital gains. She will be subject to the surtax on the lesser of NII (\$75,000) or the excess of MAGI over the \$200,000 threshold amount for single taxpayers (\$65,000), so the amount subject to the surtax is \$65,000. If Kay recognizes \$30,000 of capital losses, reducing her NII to \$45,000, she also reduces the amount subject to the surtax by \$30,000. The base for calculating the surtax is now the lesser of \$45,000 or (\$235,000 - \$200,000), or \$35,000. The reason for this result is that reducing NII also reduces MAGI.

The same cannot be said for decreasing MAGI, however. If the excess of MAGI over the threshold amount initially exceeds the amount of NII, non-NII reductions in MAGI will not reduce the surtax until the excess amount and NII are equal. Consider the following example.

Example 2: Tom, a single taxpayer, has MAGI of \$500,000, including \$100,000 of NII. Recall that the threshold amount for a single taxpayer is \$200,000. Thus, Tom's excess MAGI over the threshold amount is \$300,000. Since his NII is less than this amount, he will initially be subject to the surtax on \$100,000. Suppose that Tom can reduce non-NII MAGI by \$75,000. This reduces his excess amount to \$225,000, but since NII is still lower the reduction makes no difference. If Tom can reduce non-NII MAGI by more than \$200,000, though, he will reduce the amount subject to the surtax dollar for dollar. With a reduction of \$300,000, the amount subject to the surtax will drop to \$0 even though Tom still has \$100,000 of NII.

The point to note here is that if taxpayers are trying to reduce exposure to the surtax after 2012, they can always do so by using a planning strategy that reduces NII. If they are using a strategy to reduce non-NII MAGI, however, it will only help to the extent it reduces the MAGI excess amount below the amount of NII. With that caveat in mind, let us now turn to some specific strategies for eliminating surtax.

## **Specific Strategies**

As noted above, there are two kinds of strategies for minimizing exposure to the surtax: (1) strategies that reduce NII and (2) strategies that reduce MAGI. To be more precise we should perhaps say (1) strategies that reduce both NII and MAGI, because any reduction in NII will produce a corresponding reduction in the MAGI excess amount and (2) strategies that reduce only MAGI. Nevertheless we will analyze the strategies according to their main effect.

## **Reducing Net Investment Income (NII)**

# **Tax Exempt Bonds**

While interest on corporate bonds is NII, interest on tax exempt bonds is not. Thus, for affected taxpayers, the surtax can clearly be reduced by switching from corporate bonds to tax exempt bonds. But is this always a good idea? The bottom line on taxable bond investments is after-tax return.

#### **Tax Deferred Annuities**

This strategy can reduce the surtax by making favorable changes in the timing of NII and MAGI. For example, if a taxpayer has NII and MAGI above the threshold amount in 2013 but expects to have much lower income later when she retires, a purchasing a deferred annuity can move NII and MAGI to years when they won't produce any surtax.

#### Life Insurance

A similar income smoothing result can be produced with a whole life insurance policy. By purchasing the policy, the taxpayer can reallocate money from assets producing current NII and/or MAGI to assets that are creating neither. The taxpayer could then withdraw basis from the policy in lower income years.

#### **Rental Real Estate**

As its name indicates, NII includes only <u>net</u> investment income. This means that investment losses can not only reduce investment income from an activity, but may even create a net loss that can be used to offset investment income from other activities. For example, depreciation deductions on rental real estate might exceed rental income. If so, the net loss can be used to offset other investment income like interest.

#### Oil and Gas Investments

If a taxpayer has particularly high income (and surtax) in a given year, the intangible drilling costs (IDCs) associated with oil and gas investments can produce a large current deduction. This deduction may be as much as 80% of the amount invested in a well.

# **Choice of Accounting Year for Trusts and Estates**

The surtax applies to tax years ending after December 31, 2012. This means that if a trust or estate can choose between a tax year beginning in late 2012 rather than early 2013 it can realize significant tax savings.

# **Timing of Estate and Trust Distributions**

Recall that for trusts and estates, the surtax applies to the lesser of (1) undistributed net investment income or (2) the excess of AGI over the threshold amount (currently \$11,200). Given the low threshold amount, most NII of a trust or estate will be subject to the surtax unless it is distributed. If the beneficiaries would not be subject to the surtax on distributions, surtax could be saved by distributing enough of the net

income to reduce undistributed income below \$11,200.

## **Reducing MAGI**

The key strategies for reducing MAGI are (1) Roth IRA conversions, (2) charitable remainder trusts (CRTs), (3) charitable lead trusts (CLTs), (4) installment sales and (5) above-the line deductions.

#### **Roth IRA conversions**

The MAGI rules for IRAs are as follows:

- (1) Distributions from traditional IRAs are included in MAGI;
- (2) Income from Roth IRA conversions is included in MAGI; but
- (3) Distributions from Roth IRAs are not included in MAGI.

This means that taxpayers who would otherwise be subject to the surtax on distributions from their traditional IRAs can completely avoid the tax by doing a Roth IRA conversion before 2013.

Before deciding to do a current Roth conversion, however, taxpayers should do a comprehensive mathematical analysis to make sure it provides an overall benefit. The most important factor in this analysis is a comparison of the income tax rate on a conversion with the expected income tax rate on distributions. If the tax rate on the conversion is lower than the expected tax rate on distributions, the conversion will produce a better overall tax result. If the tax rate is expected to be lower at the time of distribution, however, it may be better not to convert.

The surtax and scheduled increase in rates for 2011 make it much more likely that a high income taxpayer will have a lower rate for a 2010 conversion than she would have on later distributions from a traditional IRA. For such taxpayers, the difference in tax rates between converting to a Roth IRA in 2010 and paying income tax plus surtax on traditional IRA distributions in 2013 and later years could be as much as 8.4% (39.6% + 3.8%) - 35%. Although the difference is less dramatic, the tax rate on a 2011 or 2012 conversion would still be 3.8 percent lower than the rate on distributions for top bracket taxpayers.

There are several other factors that weigh in favor of doing a Roth conversion. One is having funds outside the traditional IRA that can be used to pay the tax on the conversion. Paying the tax with outside funds has the same effect as being able to get more assets into the IRA and significantly increases the economic benefit.

Another favorable factor for taxpayers who don't need to live on IRA distributions is that unlike a traditional IRA, there are no required distributions from a Roth IRA. This allows more money to stay in the IRA to grow tax-deferred for heirs and increases the amount that can be accumulated. Finally, a Roth IRA gives a taxpayer the ability to take early distributions of contributions without paying the 10 percent penalty applicable to traditional IRAs.

#### **Charitable Remainder Trusts**

These trusts pay a lead annuity or unitrust interest to the grantor or another non-charitable beneficiary, with the remainder interest passing to charity at the end of the trust term. An annuity interest is payment of a fixed percentage of the initial value of the trust assets each year. This means that the payments are the same each year. By contrast, a unitrust interest is payment of a fixed percentage of the trust assets re-determined each year to reflect changes in the value of the trust assets so that payments vary every year. Charitable remainder trusts (CRTs) that pay an annuity to the lead beneficiary are called charitable remainder annuity trusts (CRATs) and charitable remainder trusts that pay a unitrust amount are referred to as charitable remainder unitrusts (CRUTs).

The surtax does not apply to CRTs (either CRATs or CRUTs) because they are exempt from tax under I.R.C. section 664(c). This means that if a taxpayer contributed appreciated capital gain property to a CRT, the trust could sell the property without paying any surtax. Moreover, the gain would have no immediate effect on the grantor's MAGI. Rather, the taxpayer would have no MAGI until he received annuity or unitrust payments from the trust. This might enable the taxpayer to spread out MAGI and avoid having it exceed the threshold amount in any given year. The trade-off for this planning advantage is that the charity must be given a remainder interest with a value equal to at least 10 percent of the present value of the property transferred to the trust. The grantor

receives an income tax deduction for the gift, however, reducing the cost of the charitable contribution.

#### **Charitable Lead Trusts**

Charitable lead trusts (CLTs) could be thought of as charitable remainder trusts in reverse. Instead of having non-charitable lead beneficiaries receiving payments for a period of time and charitable remainder beneficiaries, a CLAT has charitable lead beneficiaries with the remainder interest passing to non-charitable beneficiaries, typically the grantor's heirs. Charitable lead trusts are almost invariably charitable lead annuity trusts (CLATs) rather that charitable lead unitrusts (CLUTs).

It is important to distinguish between two types of CLATs--grantor CLATs and non-grantor CLATs. In a grantor CLAT, the grantor is treated as the owner of the trust under the grantor trust rules and all items of trust income are reported on the grantor's individual tax return. The grantor receives a charitable deduction for the present value of the charity's lead interest when the trust is created but must pay the income tax on all the trust's income. In a non-grantor CLAT, the trust pays tax on its own income but receives a charitable deduction as it makes its annual annuity payments to the charitable lead beneficiary.

Grantor CLATs do not help with the surtax because all the trust income is taxed to the grantor, but non-grantor CLATs may be useful. Unlike CRTs, charitable lead annuity trusts are not exempt from the surtax, but they can use the charitable deductions they receive for the annuity payments they make to charity to offset any income.

#### **Installment Sales**

These can be used to spread out net investment income and MAGI in much the same manner as a charitable remainder trust. They may enable a taxpayer to avoid surtax exposure in the year of sale and in subsequent years.

#### **Above-the-Line Deductions**

Deductions that can be claimed on page one of Form 1040 reduce MAGI. Two of the most important are contributions to qualified plans and traditional IRAs and charitable contributions.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

# Bob Keebler

# **CITE AS:**

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