Robert S. Keebler, CPA, MST: Understanding the Health Care Surtax

Statutory Overview

I. OVERVIEW OF NEW TAX EFFECTIVE JANUARY 1, 2013

A. A new 3.8% Medicare surtax is assessed on the *lesser of*:
   1. "Net investment income" *OR*
   2. The excess of "Modified Adjusted Gross Income" (MAGI) over the "threshold amount"

B. "*Net investment income*" – is the sum of gross investment income over allocable investment expenses
   1. "Investment income" (for purposes of the 3.8% surtax) includes:
      a. Interest
      b. Dividends
      c. Capital gains
      d. Annuities
      e. Rents
      f. Royalties
      g. Passive activity income
   2. "Investment income" does ***not*** include:
      a. Active trade and/or business income
      b. Any of the above sources of income in "B1" above (e.g. interest, dividends, capital gains, etc.) to the extent it is derived in an active trade and/or business
      c. Distributions from IRAs or other qualified retirement plans
      d. Any income taken into account for self-employment tax purposes
   3. Other limitations on "investment income"
      a. Gain on sale of an active interest in a partnership or S-corporation
         i. Gain included as "investment income" is limited to the net gain that would be recognized if all of the partnership/S-corporation interests were at fair market value (FMV)

C. "*Modified Adjusted Gross Income*" (MAGI) – is the sum of adjusted gross income (i.e. 2010 Form 1040, Line 37) plus the net foreign income exclusion amount.

D. "*Threshold amount*"
   1. Married taxpayers filing jointly – $250,000
   2. Married taxpayers filing separately – $125,000
   3. All other individual taxpayers – $200,000
   4. Trusts and estates - $11,650

II. WHO DOES THE NEW TAX AFFECT?

A. MAGI ≤ "threshold amount" = No application of 3.8% Medicare tax

B. Excess of MAGI > "threshold amount" = Application of 3.8% Medicare tax to lesser of investment income or excess over MAGI

Married Filing Jointly Table

2011 Taxable Income	*2011*	*2012 Taxable Income*	*2012* [2]	*With Surtax 2013* [1]
$0 – 17,000	10%	$0 – 17,400	10%	15%
$17,000 – 69,000	15%	$17,400 – 70,700	15%	15%
$69,000 – 139,350	25%	$70,700 – 142,700	25%	28%
$139,350 – 212,300	28%	$142,700 – 217,450	28%	34.8%
$212,300 – 379,150	33%	$217,450 – 388,350	33%	39.8%
Over $379,150	35%	Over $388,350	35%	43.4%

[1] The top rate with surtax in 2013 is simply the expected rates for 2013 in addition to the surtax rate of 3.8%.
[2] The capital gain rate will increase for high income taxpayers to 20% in 2013 and the 3.8% surtax will apply in 2013 for a total capital gain rate of 23.8%.

Estates and Trusts

I. The threshold for Trusts and Estates is $**11,650** (top tax bracket amount in 2012).

II. Estates and electing trusts must select the proper year to reduce the surtax.

Example: *Mary dies in January 2012. Her estate elects a November 30, 2012 year end. The surtax will not apply until the year beginning December 1, 2013.*

III. Distributions to beneficiaries will carry out DNI.

IV. Charitable remainder trusts can be used to "smooth out" income.

V. Non-grantor charitable lead trusts allow an "above the line" charitable deduction – IRC § 642(c) offsetting surtax income.

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Investment Income and MAGI Strategies

III. PLANNING CONSIDERATIONS

A. Qualified retirement plans – reduce MAGI
   1. Contributions to 401(k) plans, 403(b) plans, 457 plans, IRAs, etc.
   2. Creation of "alternative" qualified retirement plans (e.g. defined-benefit plans)
   3. Roth conversions – 2010 through 2012
      a. Today's top rate is 35%
      b. 2013 top rate is 43.6%
      c. Arbitrage of 8.6%

B. Tax-exempt/tax-deferred investments – reduce MAGI and investment income
   1. Municipal bonds – remain tax exempt
      a. Critical for trusts
   2. Tax-deferred non-qualified annuities (during deferral period)
      a. "Leapfrog" over high income years
      b. Part of MAGI and investment income during distribution period
   3. Non-Qualified Deferred Compensation (NQDC)
      a. Reduces investment income
   4. Life insurance
      a. Modified Endowment Contract (MEC) policies
         i. Earnings withdrawal first
         ii. No policy loans
      b. Non-MEC policies
         i. Basis is withdrawn first
         ii. Loans are not taxable
      c. No taxable income at death
   5. Oil and gas
      a. Immediate deduction of up to 95% of initial investment
      b. Depletion allowances
   6. Real estate investments
      a. Depreciation tax shield reduces income
   7. Security sales
      a. Accelerate gains before 2013
      b. Collars
      c. Merger shorts to generate capital losses
   8. Timing of pre-2013 income
      a. Accelerate bond interest income into 2012
         i. Timing of interest payments (focus on December 2012 payments)
         ii. Sell "ripe" bonds before 2013
         iii. Repurchase different bonds in January 2013
   9. Dividend income
      b. Timing of dividends
      c. Return of capital dividends
   10. Installment sales
      a. Defer recognition of income over a period of time (to get under the MAGI threshold)

C. Roth IRA conversions
   1. Roth IRA distributions will not count towards MAGI
   2. Roth IRA conversion income does count towards MAGI
   3. Payment of income tax using non-qualified accounts (i.e. "outside assets") will generally result in lower future "net investment income"
   4. The "Surtax Bubble℠" is a key concern
      a. RMDs from Traditional IRAs
         i. Exempt from the surtax
         ii. Increase MAGI
         iii. Creates a 43.6% effective tax rate on IRA distributions
   5. Because of the expiration of the Bush administration tax cuts, the Roth opportunity should be explored in 2010.

D. Charitable trusts
   1. Charitable remainder trusts (CRTs)
      a. Defer recognition of income over a period of time (to get under the MAGI threshold)
      b. Smooth out spikes in income
      c. Exempt from the surtax
   2. Non-grantor charitable lead trusts (CLTs)
      a. Shift income away from grantor to trust – reduce MAGI
      b. More tax efficient under the MAGI computation formula
      c. Charitable deduction is "above" the line
      d. No percentage limitations on charitable deductions

"Surtax Bubble" ℠ 2011 and 2012 Roth Conversions

Converting to a Roth today will reduce MAGI tomorrow – the "Surtax Bubble"℠

Example: Tom and Sue age 69 have "investment income" of $249,000. Next year they are required to begin required minimum distributions. If they take an RMD of $100,000 their MAGI will increase to $349,000 and $99,000 is subject to the surtax.

YEAR 1		
(1) Investment Income	$	249,000
IRA Distribution (i.e. RMD)		-
MAGI	$	249,000
Less: Threshold		(250,000)
(2) Excess Over Threshold	$	-
Amount Subject to Medicare Surtax (Lesser of: 1 or 2 above)	$	-
Medicare Surtax (3.8%)	**$**	**-**

YEAR 2		
(1) Investment Income	$	249,000
IRA Distribution (i.e. RMD)		100,000
MAGI	$	349,000
Less: Threshold		(250,000)
(2) Excess Over Threshold	$	99,000
Amount Subject to Medicare Surtax (Lesser of: 1 or 2 above)	$	99,000
Medicare Surtax (3.8%)	**$**	**3,762**

Conversion should occur in 2011 and 2012 before the surtax.

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Health Care Surtax Examples

1. **John, single, has $100,000 of salary and $50,000 of net investment income.**
   - *The 3.8% surtax would not apply (MAGI <$200,000).*
2. **Mary, single has $225,000 of net investment income and no other income.**
   - *The 3.8% surtax would apply to $25,000 of income (excess of $225,000 MAGI over $200,000 "threshold amount").*
3. **Terry and Tina, married filing jointly, have $300,000 of salaries and no other income.**
   - *The 3.8% surtax would not apply (no net investment income).*
4. **Peter and Paula, married filing jointly, have $400,000 of salaries and $50,000 of net investment income.**
   - *The 3.8% surtax would apply to $50,000 of net investment income (lesser of rule).*
5. **Scott and Sarah, married filing jointly, have $200,000 of salaries and $150,000 of net investment income.**
   - *The 3.8% surtax would apply to $100,000 of income (lesser of rule excess of $350,000 MAGI over $250,000 "threshold amount").*
6. **Randy, a single taxpayer, age 69, has investment income of $200,000 and is not subject to the surtax. In the following year, Randy has an RMD from his IRA of $125,000. In this case, $325,000 of MAGI exceeds the $200,000 threshold and $125,000 is subject to the 3.8% surtax.**

This is called the "surtax bubble SM"

	Regular IRA	Roth IRA
Investment Income	$ 200,000	$ 200,000
IRA Income	$ 125,000	$ 0
MAGI	$ 325,000	$ 200,000
Less Threshold Amount	$ (200,000)	$ (200,000)
Amount Subject to Surtax	$ 125,000	$ 0
Surtax @ 3.8%	$ 4,750	$ 0
Surtax over 10 years	$ 47,500	$ 0

7. **The John Smith Trust has investment income of $51,000 and no distributions.**
   - *$39,350 of income ($51,000 - $11,650 top bracket amount) will be subject to the 3.8% surtax.*
8. **David and Veronica, age 75, have pension and IRA income of $750,000, $25,000 of tax-exempt income and no taxable investment income. The 3.8% surtax does not apply regardless of income because they have no net investment income.**
   - *A Roth conversion will be surtax neutral.*
9. **Jill, age 60, has wages and pensions of $200,000 and 2012 interest income from CDs of $300,000. She moves half of her investments into an annuity and purchases a life insurance policy with the remaining CDs.**
   - *In 2013 all of her interest is sheltered in either the annuity or the life insurance policy and she is not subject to the 3.8% surtax.*
10. **Eliot, a widower, earns wages of $175,000 and owns an interest in a publicly traded real estate partnership which generates taxable income of $50,000.**
    - *$25,000 (excess of $225,000 MAGI over $200,000 "threshold amount") will be subject to 3.8% surtax.*
11. **Larry, a widower, earns wages of $175,000 and owns an interest in a closely-held real estate partnership which generates taxable income of $75,000.**
    - *His MAGI is $250,000 and $50,000 will be subject to the surtax (lesser of rule).*
12. **Bruno, a single person, earns wages of $200,000 and receives royalties of $60,000 from an oil and gas limited partnership.**
    - *$60,000 will be subject to the surtax (excess of $260,000 MAGI over $200,000 "threshold amount").*
13. **Mary and David earn wages of $260,000 and receive a trust distribution of $90,000 (100% dividends).**
    - *$90,000 (net investment income) will be subject to the 3.8% surtax.*
14. **The estate of Jane Smith earned $111,650 of dividends and made no distributions.**
    - *Assuming a threshold exemption of $11,650, $100,000 will be subject to the 3.8% surtax.*
15. **The estate of Jane Smith earned $111,650 of interest and made a distribution of 100% of income.**
    - *The income will be reported by the heirs and the estate will not be subject to the 3.8% surtax.*
16. **Bob and Bonnie have interest income of $248,000 and no other income. They convert Bob's $300,000 IRA to a Roth IRA which increases AGI to $548,000.**
    - *Under the lesser of rule, $248,000 will be subject to the 3.8% surtax; this is the lesser of $298,000 of excess MAGI ($548,000 -$250,000) or $248,000 of investment income.*
17. **In 2010, Randy converts a $1,000,000 IRA to a Roth IRA incurring $450,000 of state and federal income tax. Randy pays the income taxes from his outside/taxable investment funds.**
    - *Future investment income from the outside funds will no longer exist and avoid the 3.8% surtax.*
18. **Daniel and Donna have wages of $250,000 and investment income of $45,000. Their employer creates a new deferred compensation plan allowing a contribution of up to 20% of income (i.e. $50,000).**

2013	Without Planning	With Planning
Wages	$ 250,000	$ 200,000
Investment Income	$ 45,000	$ 45,000
MAGI	$ 295,000	$ 245,000
Threshold	$ 250,000	$ 250,000
Amount Subject to Surtax	$ 45,000	$ 0
Surtax @ 3.8%	$ 1,710	$ 0
Surtax over 10 years	$ 17,100	$ 0
Surtax Savings		$ 17,100

19. **Gary and Barb, age 69, have pension income of $130,000 and investment income of $115,000 for a total MAGI of $245,000, just below the threshold amount. In 2013, their Roth IRA withdrawal will be $50,000.**
    - *No 3.8% surtax will apply because the $50,000 Roth IRA distribution does not count towards MAGI.*
20. **Thor and Kristen, age 69, have pension income of $100,000 and net investment income of $75,000 for a total MAGI of $175,000, well below the $250,000 threshold amount.**
    - *In 2013, their RMDs will be $50,000 bringing MAGI to $225,000, which is still below the threshold amount.*
21. **Art and Patricia, 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 brings their MAGI to $295,000.**
    - *MAGI is $45,000 above the threshold amount ($295,000 less $250,000).*
    - *The surtax will be imposed on the lesser of $45,000 or their net investment income of $115,000. (i.e., $45,000).*
    - *A 2011 or 2012 Roth conversion would eliminate the RMDs and the surtax would not apply.*
22. **Same facts, except they convert in 2013 and the pension is $30,000. The conversion would be added to MAGI of $195,000 and their entire net investment income of $115,000 will be subject to the surtax.**

2013	Without Conversion	With Conversion
(1)Pension Income	30,000	30,000
IRA Distribution (i.e. RMD)	50,000	50,000
Roth IRA Conversion		200,000
Investment Income	115,000	115,000
MAGI	$ 195,000	$ 395,000
Less: Threshold	(250,000)	(250,000)
(2) Excess Over Threshold	$ (55,000)	$ 145,000
Amount Subject to Medicare Surtax (Lesser of: 1 or 2 above)	$ -	$ 115,000
Medicare Surtax (3.8%)	**$ -**	**$ 4,370**

23. **Brian and Betty, age 69, have annual pension income of $260,000 and net investment income of $115,000 for a total gross income and MAGI of $375,000. In 2013, their RMDs from IRAs will be $50,000 bringing MAGI to $425,000.**
    - *Because their "fixed" non-investment income of $260,000 (e.g. pensions) is over the $250,000 threshold amount, their surtax reduction planning must focus on reducing net investment income, not on reducing MAGI.*
    - *A Roth conversion will be surtax neutral; however, such a conversion may still be beneficial.*

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