

## Checklist for Individuals—Reducing the Surtax in 2013 and Later Years

1. Reducing investment income (NII) and MAGI—General Observations
  - a. Assuming that a taxpayer is subject to the surtax in the first place, reducing NII will always reduce the amount subject to the surtax dollar for dollar until the surtax payable is zero because all NII is MAGI.
  - b. Decreasing MAGI doesn't necessarily have the same effect
    - i. If a taxpayer is initially subject to the surtax and the excess of MAGI over the applicable threshold amount exceeds the amount of NII, non-NII reductions in MAGI will not reduce the surtax until the excess amount and NII are equal.
    - ii. Example—Marge, a single taxpayer, has MAGI of \$500,000, including \$100,000 of NII. The amount subject to the surtax is \$100,000--the lesser of NII (\$100,000) or the excess of MAGI over her \$200,000 applicable threshold amount (\$300,000). Suppose that Marge can reduce non-NII MAGI by \$40,000. This reduces her excess of MAGI over the threshold amount to 260,000, but since NII is still lower the reduction makes no difference. If Marge can reduce non-NII MAGI by more than \$200,000, though, she will reduce the amount subject to the surtax dollar for dollar. With a reduction of \$300,000, for example, the amount subject to the surtax will drop to \$0 even though Marge still has \$100,000 of NII.
2. Strategies to reduce both NII and MAGI
  - a. Tax Exempt Bonds
    - i. Interest on corporate bonds is NII
    - ii. Interest on tax exempt bonds is not
    - iii. You can reduce the surtax by switching from corporate bonds to tax-exempt bonds
    - iv. Is this a good idea given the implicit tax in the form of lower interest rates on tax exempt bonds?
    - v. Answer: Only if switching produces a higher after-tax return
    - vi. Example--Don, a single taxpayer in the 39.6% marginal income tax bracket in 2013, owns \$100,000 of corporate bonds that produce 5% interest. Taking the 3.8% surtax into account, his after-tax rate of return is 2.83% [ $5.0 \times (1 - .434)$ ]. Switching to tax-exempt bonds would make sense only if he can earn an interest rate on the tax-exempt bonds in excess of 2.83%.
    - vii. As a general rule, switching to tax-exempt bonds would make sense for high bracket taxpayers but not for low bracket taxpayers.
  - b. Tax Deferred Annuities
    - i. Can reduce the surtax by making favorable changes in the timing of NII and MAGI.
    - ii. NII and MAGI can be moved to years when they won't produce any surtax because income is lower.

iii. Example—Cindy, a single taxpayer, has salary income of \$175,000 and interest income of \$50,000. This gives her NII of \$50,000 and excess MAGI of \$25,000 (\$225,000 - \$200,000), so she will pay surtax on \$25,000. Assume that Cindy will retire in 2020, at which time her annual income will consist of \$90,000 RMDs from her IRA plus \$50,000 of interest income at that time. If she reinvests the interest-producing assets in an annuity that defers payments for seven years and pays her \$70,000 per year in retirement, Cindy will reduce her current income to \$190,000 and her NII to \$0, eliminating all current surtax. She will not pay surtax after retirement either, because the sum of her RMDs (\$90,000) plus the \$70,000 annuity payments will leave her MAGI below the threshold amount at \$160,000/year.

c. Life Insurance

- i. Can be used to produce a similar smoothing effect on income
- ii. Taxpayer switches funds currently producing NII and MAGI to an investment in life insurance that currently produces neither.
- iii. Earnings could be withdrawn from the policy in lower income years when no surtax would be payable

d. Rental Real Estate

- i. NII includes only net investment income
- ii. Depreciation deductions can offset income from rental real estate, reducing net investment income
- iii. If depreciation deductions create a net loss in the rental activity, they can also offset NII from other sources (e.g., interest or dividends)

e. Oil and Gas Investments

- i. Can produce a large current deduction to reduce or eliminate surtax in high income years
- ii. Up to 80% of the amount invested in a well can be deducted
- iii. Example--Chuck and Kay, married taxpayers filing jointly, are in the 39.6% marginal income tax bracket in 2013 and have \$150,000 of NII subject to the surtax. They invest \$100,000 in a working interest in an oil well. The investment produces the following tax benefits.

|                                |                                  |
|--------------------------------|----------------------------------|
| 2013 income tax deduction..... | \$32,000 (.8 x .396 x \$100,000) |
| Surtax savings.....            | \$3,400 (.8 x .038 x \$100,000)  |
| Total tax savings.....         | \$35,400                         |

3. Strategies to Reduce MAGI

a. Roth IRA Conversions

- i. Neither distributions from an IRA nor income from a Roth IRA conversion are NII
- ii. IRA MAGI rules
  - 1. Distributions from traditional IRAs are included in MAGI
  - 2. Income from a Roth IRA conversion is included in MAGI
  - 3. Distributions from Roth IRAs are not included in MAGI

- iii. This means that a pre-2013 Roth IRA conversion can eliminate all IRA income from MAGI
  - iv. Example—Roy is a single taxpayer with \$180,000 of NII and RMDs of \$90,000 per year from his traditional IRA. If he leaves the assets in the traditional IRA, his NII for 2013 and subsequent years will be \$180,000 and his MAGI will be \$270,000. Thus, he will pay surtax on \$70,000 of income each year (lesser of \$180,000 or \$70,000). Roy can avoid the surtax by doing a Roth IRA conversion before 2013. This will convert the \$90,000 RMD payments that are included in MAGI to \$90,000 Roth distributions that are not included in MAGI, reducing his MAGI to \$180,000 and eliminating the surtax. This would save John \$3,420 (.038 x \$90,000) each year beginning in 2013. Note that there is no surtax payable on the conversion because the tax does not yet apply in 2012.
  - v. A comprehensive mathematical analysis necessary to determine if a Roth conversion provides an overall economic benefit, however
  - vi. Factors favoring a Roth conversion
    - 1. Lower tax rate at time of conversion than at time when distributions will be received
      - a. The surtax makes it more likely that this will be the case
      - b. A phase-out of Bush administration tax cuts would also make this more likely
    - 2. Ability to pay the conversion tax with outside funds
    - 3. Taxpayer doesn't need IRA distributions to live on
    - 4. Taxpayer may wish to take early distributions
- b. Charitable Remainder Trusts (CRATs and CRUTs)
- i. Lead annuity or unitrust interest to the grantor or another non-charitable beneficiary
  - ii. Remainder to charity
  - iii. No current MAGI on sale of appreciated capital gain property by a CRT because they are exempt from tax under IRC § 664(c)
  - iv. A taxpayer can spread out MAGI over annual CRT payments to avoid exceeding threshold amount in any tax year
  - v. Downside—must give charity a remainder interest having a present value equal to at least 10% of the value of the assets transferred to the trust
    - 1. But, the taxpayer gets a charitable deduction for the remainder interest
  - vi. Example—Will, a single taxpayer in the 39.6% tax bracket, owns non-business capital gain property with a basis of \$30,000 and FMV of \$200,000. Will has salary income of \$190,000 and no other income. He can either sell the property and recognize the full gain of \$170,000 in 2013 or contribute it to a CRAT that pays him an annuity of \$10,000/year for 20 years. If Will sells the property himself in 2013, he will have \$160,000 of income subject to the surtax. By contrast, if he contributes the property to the CRAT and the CRAT sells it, he will have \$200,000 of income in each of the next 20 years (\$180,000 salary + \$20,000 annuity payment), preventing his income from rising above the applicable threshold amount and avoiding all surtax

- c. Installment Sales
  - i. Can be used to spread out MAGI in much the same manner as with a CRT
  - ii. Taxpayer may be able to structure the payments to keep MAGI below the applicable threshold amounts in year of sale and all subsequent years
  
- d. Above-the-Line Deductions
  - i. Reduce MAGI
    - 1. Recall that MAGI is generally AGI (last line of page 1 of Form 1040)
  - ii. Some above-the-line deductions--
    - 1. Charitable deductions
    - 2. Contributions to qualified plans and traditional IRAs
    - 3. Losses on the sale of property
    - 4. Higher education expenses
    - 5. Health savings accounts

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