



Planning For The New Medicare Contribution Tax on Unearned Income

On March 30th, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010 which, when combined with the Patient Protection and Affordable Care Act of 2010 signed on March 23rd, will form the basis of a new health care system in the United States for many years to come.

Under the broad new rules, all individuals not covered by Medicare or Medicaid will be required to obtain health care coverage or pay a penalty, unless they are exempt from the individual responsibility mandate. Employer coverage will generally satisfy the universal coverage requirement, but the legislation also provides for the possibility of state insurance exchanges where individuals can shop for coverage on their own. Lower-income individuals, as well as some "middle-income" families, may qualify for a premium assistance tax credit, cost-sharing, or a voucher to help pay for health insurance.

To help offset some of the anticipated costs of the legislation, Congress enacted several provisions to control costs and/or raise revenues, including a new "unearned income Medicare contribution tax" that will take effect in 2013. In this month's newsletter, we will explore this new tax, its technical rules, and the planning implications and opportunities that financial planners must contend with in the future.

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Technical Rules

Under the new IRC Section 1411 (created by the health care legislation), a new unearned income Medicare contribution tax will be levied, effective for tax years beginning after December 31, 2012. Under IRC Section 1411(a)(1), the tax will be assessed on individuals at a rate of 3.8%, and will apply to the *lesser* of:

- a) Net investment income; or
- b) The excess of modified Adjusted Gross Income (MAGI) over the applicable threshold amount

The 3.8% tax applies in addition to any other taxes that would otherwise apply to the associated income. This also means that clients will need to make estimated tax payments based on their total anticipated tax liability, *including* the Medicare contribution tax if it will apply.

In order to apply the above rules for the Medicare contribution tax, though, it is necessary to define several key terms and phrases.

Net Investment Income

The term "net investment income" is defined explicitly under the tax code for the purposes of the Medicare contribution tax; although it is very similar to net investment income used in the context of determining the amount of investment expenses that can be deducted, the rules are slightly different.

For the purposes of the Medicare contribution tax, net investment income under IRC Section 1411(c) is the sum of:

- a) gross income from interest, dividends, annuities, royalties, and rents;
- b) other gross income derived from a passive activity (e.g., real estate investing) or a trade or

business of trading in financial instruments or commodities; and

c) net gain attributable to the disposition of property

The total of (a), (b), and (c) are then reduced by any deductible investment expenses that would be allowed to the taxpayer. In addition, for the purposes of determining net investment income, anything that otherwise would be excluded from gross income for general tax purposes is also excluded from net investment income for Medicare contribution tax purposes (e.g., tax-exempt municipal bond interest, excluded gain from the sale of a principal residence, etc.).

Any income or net gains attributable to or derived in the ordinary course of a trade or business are excluded from net investment income for the purposes of the Medicare contributions tax, as long as the business is not a passive activity or a business trading in financial instruments or commodities. Thus, any income associated with a "normal" business of any other type (i.e., generally, one in which the taxpayer materially participates) will not be subject to the Medicare contributions tax; however, an exception under the new rules does state that investment income associated with the working capital of certain businesses may still be included for net investment income purposes. On the other hand, gains from the sale of a partnership or S corporation business will only be treated as net gain for the purposes of the Medicare contribution tax to the extent that gain would have occurred for the seller if the business had sold all of its property for fair market value (i.e., gains for the sale of a business are excluded unless they represent gains from the sale of the business' underlying property). Notwithstanding all of the above, the rules also state that investment income will never include any amount of income to which self-employment taxes already applied; in other words, if an item of income is included for self-employment income tax purposes, it cannot also be included in net investment income for the purposes of the Medicare contribution tax.

The new rules also explicitly state that any distributions from a retirement plan are not included in investment income, including distributions from plans under the following IRC sections:

- 401(a) (qualified employer retirement plans, including most defined contribution and defined benefit plans)

- 403(a) and 403(b) (qualified annuity plans and annuities for employees of tax-exempt organizations)

- 408 and 408A (IRAs and Roth IRAs)

- 457(b) (deferred compensation plans for state and local governments and tax-exempt organizations)

At this point, many commentators suggest that non-qualified deferred compensation will also not likely fall under the rules for net investment income, although the definitive treatment of such income is not entirely clear at this time. (Expect a high probability that the Treasury will issue further guidance to resolve this uncertainty sometime before the tax's 2013 effective date.)

Modified Adjusted Gross Income

As indicated earlier, the second test for determining the amount of income subject to the Medicare contribution tax is the excess of "modified" Adjusted Gross Income (MAGI) over the applicable threshold amount (defined next).

In this case, under IRC Section 1411(d), modified AGI simply means Adjusted Gross Income (i.e., AGI, as determined from the front page of the tax return), increased by the amount of any income that was excluded under the foreign earned income exclusion (to the extent it exceeded any deductions that were disallowed as a part of those rules).

Applicable Threshold Amount

In order to evaluate how much MAGI exceeds the applicable threshold amount, it is also necessary to define such amounts. Under IRC Section 1411(b), the applicable threshold amounts will be:

- \$250,000 for married filing jointly returns, and surviving spouses

- \$125,000 for married taxpayers filing separately

- \$200,000 for all other taxpayers (i.e., single, head of household, etc.)

The threshold amounts above are *not* indexed for inflation.

Applying the Rules

As stated earlier, the 3.8% Medicare contribution tax will be applied to the *lesser* of net investment income, or the excess of the individual's MAGI over the applicable threshold amount (generally, \$250,000 for couples and \$200,000 for individuals).

For example, Figure 1 below shows a comparison of four different individual investors. The horizontal red bar represents the applicable threshold amount (\$200,000 for these investors, as individual taxpayers). The brown area represents the investors' net investment income, resting on top of their other forms of income (the blue area). Graphically speaking, this means the investors will be subject to the Medicare contributions tax to the extent that the brown section (their net investment income) exceeds the red bar (the applicable threshold amount).

In the case of investor A, this follows because the investor's total MAGI would be a total of \$175,000, which is below the \$200,000 applicable threshold amount; consequently, the excess of MAGI above the threshold is \$0, the lesser of net investment income or \$0 is \$0, and consequently the Medicare contribution tax liability will be \$0.

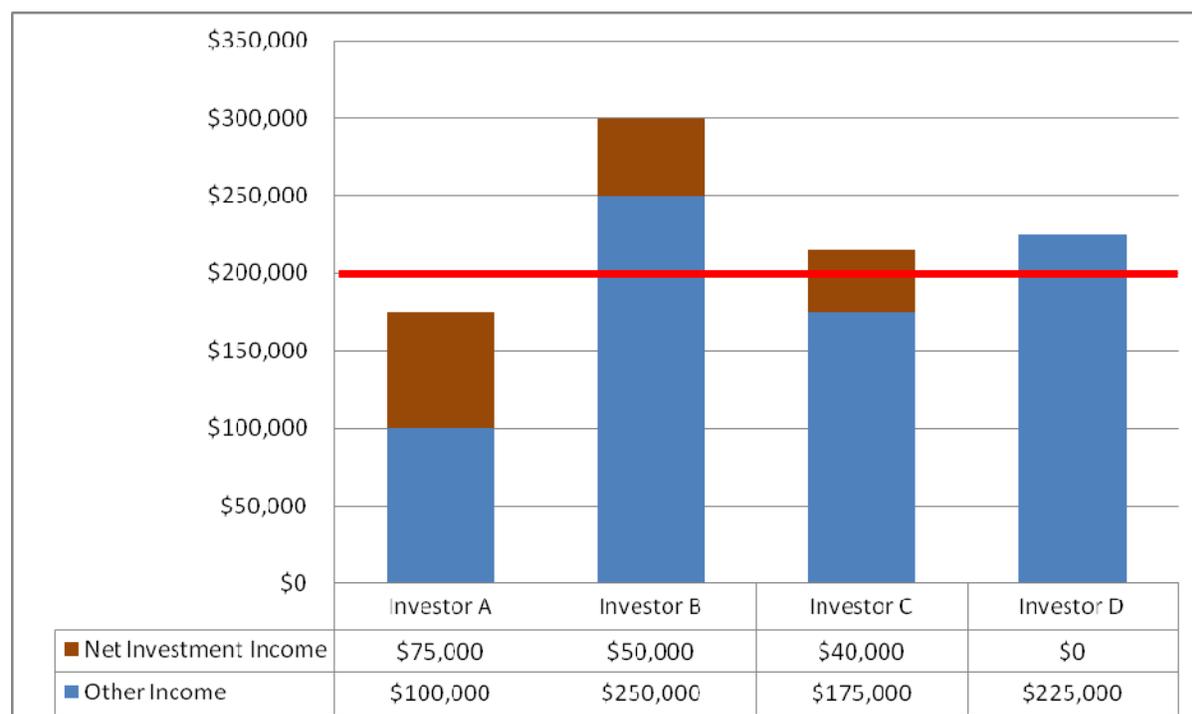
For investor B, net investment income is \$50,000, and total MAGI of \$300,000 would be \$100,000 in excess of the threshold amount. Since the Medicare contributions tax is owed on the lesser of net investment income or the excess of MAGI over the threshold, investor B owes the new Medicare tax on the \$50,000 of net investment income.

For investor C, net investment income is \$40,000, and MAGI is a total of \$215,000. Accordingly, the Medicare contribution tax will apply to the last \$15,000 of net investment income, since it is applied to the *lesser* of net investment income (\$40,000) or the excess of MAGI over the threshold (\$15,000).

For investor D, net investment income is \$0, and MAGI is a total of \$225,000. In this case, although MAGI exceeds the applicable threshold amount by \$25,000, there will be no Medicare contributions tax due, because net investment income is \$0 (and thus the lesser of net investment income {\$0} and the excess of MAGI over the threshold {\$25,000} would be \$0). Visually, this is evidenced by the fact that no portion of the brown section appears above the threshold (in this case, because there is no brown section at all, given that net investment income was \$0).

These examples can be boiled down to a relatively straightforward framework for quickly evaluating

Figure 1. Medicare contribution tax potential exposure for four investors.



whether a client might be subject to the Medicare contribution tax, according to the following steps:

- 1) Does the client have MAGI in excess of the applicable \$200,000/\$250,000 threshold amount? If not, once again there is no need to proceed further, as no Medicare contributions tax is due if MAGI doesn't exceed the threshold amount. If the client does have MAGI in excess of the threshold, then...
- 2) Does the client have any net investment income. If there is no net investment income, there is nothing to which the tax can be applied. No need to go any further. If the client does have net investment income, then...
- 3) Determine the lesser of net investment income or the excess of MAGI over the threshold, to calculate the exact amount of income subject to the 3.8% Medicare contributions tax.

The above framework may be helpful, as it highlights several important points. First of all, no client faces the Medicare contributions tax, *regardless of income*, if they don't have any net investment income. Secondly, no client faces the Medicare contributions tax, *regardless of net investment income*, if their MAGI isn't above the applicable threshold. The latter may be especially helpful in quickly evaluating the circumstances of clients, as it means any client whose MAGI is less than \$200,000/\$250,000 simply will not face the Medicare contributions tax; to the extent the client is never anticipated to exceed those thresholds, the tax continues to be a moot point; and for clients below the threshold, they only ever need worry about the tax if they anticipate rising above the threshold at some point in the future.

What About Trusts?

In the case of trusts (and estates), the 3.8% Medicare contribution tax may also apply, subject to a similar (but slightly different) set of rules.

With trusts and estates, the Medicare contribution tax is assessed on the lesser of:

- a) *Undistributed* net investment income for the tax year; or
- b) the excess of the trust or estate's AGI over the threshold amount.

Although these provisions are very similar to the rules that apply to individuals, there are some important differences. First of all, in the case of a trust or estate, the threshold amount is defined as the dollar amount that begins the highest tax bracket for the year - which would be \$11,200 in 2010. This threshold amount is dramatically lower than that which applies to individuals, and means that certain trusts may actually be at far greater exposure risk to the Medicare contribution tax than individuals are. As a small consolation, though, unlike the other applicable threshold amounts, this threshold will inherently be indexed for inflation, because it is based on the tax brackets that are adjusted annually for inflation. In point of fact, this means the amount will already likely be higher due to inflation adjustments by the time the tax first takes effect in 2013.

Another notable difference in the Medicare contribution tax with respect to trusts is that it only applies to *undistributed* net investment income. Thus, even to the extent that the trust or estate potentially faces the Medicare tax because its AGI exceeds the threshold amount, it can avoid tax exposure by making distributions to beneficiaries and receiving a deduction for distributed net income. To the extent the investment income is distributed, it will ultimately be reported on the beneficiary's tax return, and may in turn still face the Medicare contributions tax at the beneficiary level; however, in such a case the beneficiary will be able to aggregate the trust income with other income and only face the tax in excess of the far-higher individual or married couple threshold amount. Furthermore, if there are multiple beneficiaries, the income-spreading from the trust amongst several beneficiaries may make it even easier to ensure that none of the beneficiaries individually face the Medicare contribution tax, in addition to having avoided it at the trust level. Of course, this may only be possible if the trust *allows* such income distributions, and that the distributions don't result in other less favorable consequences as well (e.g., loss of asset protection benefits, or causing a subsequent estate tax exposure).

Notwithstanding the above provisions, IRC Section 1411(e)(2) explicitly excludes from the Medicare contribution tax any tax-exempt trusts under IRC Section 501, charitable remainder trusts, and trusts that are entirely for the benefit of public charities/charitable purposes. In addition, it is also notable that if the trust is a grantor trust, the tax will likely not apply to the trust, because instead the trust's income and deductions will be reported on the grantor's tax return, and it will be the grantor who must evaluate exposure to the Medicare contributions tax and pay any liability accordingly.

Initial Impact of the Medicare Contribution Tax

The most direct impact of the new Medicare contributions tax is simply the tax itself - clients will face another 3.8% tax rate on their net investment income, in addition to any other taxes also applicable to the income. Notably, this combines with other changes to tax brackets and rates that are scheduled to occur between now and 2013, including the increase in ordinary income tax brackets in 2011 due to the lapse of the Economic Growth and Tax Relief Reconciliation Act of 2001, the increase in long-term capital gains tax rates from 15% to 20% due to the lapse of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005, and the return of dividends from "qualified" rates (i.e., long-term capital gains tax rates) to ordinary income treatment due to the same lapsing tax legislation.

Accordingly, Figure 2 below shows how the top potential tax rates will change from 2010, to 2011, to 2013.

Figure 2 illustrates a number of important issues. First of all, the impact of the 3.8% Medicare tax may actually be a greater relative impact to long-term capital gains than it is to other types of ordinary income, given the lower base to which it applies. For instance, adding a 3.8% tax to a 15% long-term capital gains rate is a 25.3% tax increase at the margin (from paying \$150 in taxes per \$1,000 of gain to paying \$188 in taxes per \$1,000 of gain). With the lapsing 2010 long-term capital gains rates back to a 20% rate (and the potential for a 3.8% tax rate on top of that), higher income clients face the possibility that their total long-term capital gains tax impact may rise by a

whopping 58.7% in just three years, from \$150 in taxes per \$1,000 of gain to \$238 in taxes for the same gain. By contrast, when looking at ordinary income tax rates (where the Medicare contributions tax will generally only apply to the top three tax brackets, by virtue of the requirement for MAGI to exceed the applicable threshold amounts), the marginal impact of another 3.8% on top of a 28%, 33%, or 35% tax bracket is only 13.6%, 11.5%, and 10.9%, respectively. Even when incorporating the higher ordinary income tax brackets, taxpayers will only face a total increase in ordinary income tax rates of 6.8 to 8.4 percentage points (a 3% to 4.6% increase in tax bracket, plus a 3.8% Medicare contributions tax), compared to the 8.8 percentage point increase in long-term capital gains tax rates, and the increase will feel less severe at the ordinary income level since the starting tax rate is already higher.

Perhaps the most significant changing impact in tax rates by 2013, though, is for qualified dividends, which will both be subject to the Medicare contributions tax at higher income levels, and will revert back to ordinary income treatment from today's more favorable long-term capital gains tax rates. For clients in the highest tax brackets (facing both the rate increase and the Medicare contributions tax), their dividend tax rates will increase from 15% to 34.8% or as high as 43.4%! Granted, this impact is more from the lapse of qualified dividend tax rates in 2011 than the Medicare contributions tax in 2013, but it nonetheless represents a dramatic shift in total with respect to the taxation of dividends.

To say the least, many clients may be facing a non-trivial increase in tax rates on portfolio income in the coming years, albeit focused primarily at the top end of the income spectrum. This in turn leads to several potential planning strategies to help manage and mitigate the impact of the tax changes. Before exploring these further, though, it is necessary to explore one

Figure 2. Scheduled changes to potential maximum tax rates in coming years.

2010				2011				2013			
Ord. Income	L-T Cap Gains	Int/S-T Gains/ NQ Divs	Qual Divs	Ord. Income	L-T Cap Gains	Int/S-T Gains/ NQ Divs	Qual Divs	Ord. Income	L-T Cap Gains	Int/S-T Gains/ NQ Divs	Qual Divs
10%	0%	10%	0%	15%	10%	15%	15%	15%	10%	15%	15%
15%	0%	15%	0%					15%	10%	15%	15%
25%	15%	25%	15%	28%	20%	28%	28%	28%	20%	28%	28%
28%	15%	28%	15%	31%	20%	31%	31%	31%	23.8%	34.8%	34.8%
33%	15%	33%	15%	36%	20%	36%	36%	36%	23.8%	39.8%	39.8%
35%	15%	35%	15%	39.6%	20%	39.6%	39.6%	39.6%	23.8%	43.4%	43.4%

other aspect of the Medicare contributions tax - the crossover zone that causes the tax to apply, indirectly, to additional income that is *not* investment or capital gains income.

Medicare Tax Crossover Zone

One significant problem that arises when planning and evaluating for the impact of the Medicare contributions tax is the so-called "crossover zone" where net investment income begins to push above the applicable threshold amount, causing an increasing amount of investment income to be subject to the tax, even if no further investment income is earned.

An example may help to illustrate. Assume that John, a single taxpayer (i.e., applicable threshold amount of \$200,000) currently has \$150,000 of employment income, and \$40,000 of net investment income. Under the Medicare contributions tax rules, John will not owe any of the tax, because his MAGI would be \$190,000, which is below the \$200,000 threshold. However, let's now look at the impact when John receives a \$20,000 bonus. His "other" income rises to \$170,000, and when combined with his \$40,000 of net investment income, his MAGI grows to \$210,000, which is \$10,000 in excess of the applicable threshold. Consequently, John will owe an extra 3.8% Medicare contributions tax on the last \$10,000 of net investment income, *even though* he didn't have any new investment income! Instead, he will pay a "new" 3.8% Medicare contributions tax on part of his income, because he received more *non*-investment income - which pushed (some/more of) his investment income over the threshold.

Figure 3 (lower right) shows how the crossover zone will apply. For the (single taxpayer) investor whose total income has just reached the applicable threshold amount (\$200,000), the next \$50,000 of "other" income will push an equal amount of net investment income above the threshold, causing it to become subject to the Medicare contributions tax. Graphically, this crossover zone continues to apply until the blue section (other income)

has completely pushed all of the brown section (net investment income) up over the red line (applicable threshold).

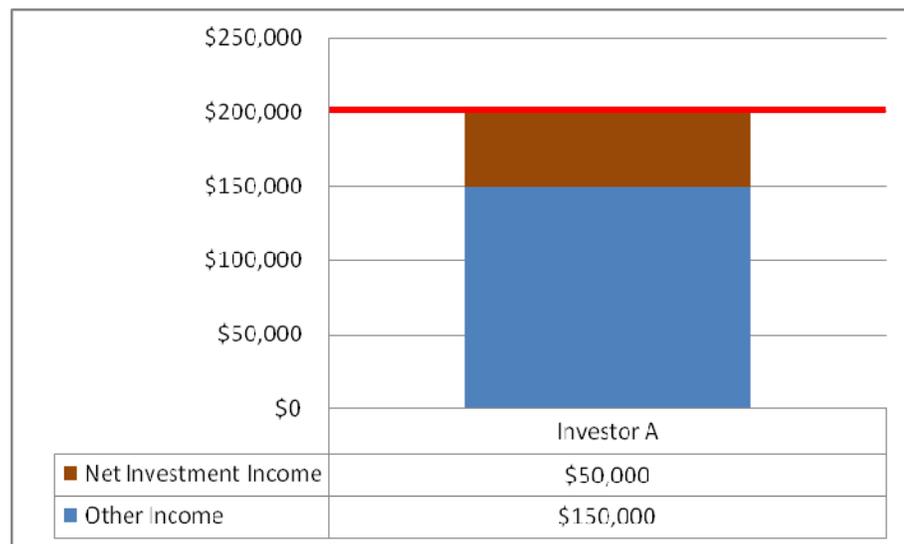
As long as total income (net investment income plus other income) hasn't reached the threshold, this crossover zone isn't an issue; similarly, once all of the net investment income is above the threshold and is fully taxed at the 3.8% rate, there is also no issue. But at the point that net investment income is *crossing over* the threshold, additional other income results - at the margin - in a 3.8% Medicare contributions tax, even if that income itself is not otherwise subject to the tax. Depending on the client circumstances, almost any form of additional income could trigger the crossover zone, whether it is an IRA withdrawal (or RMD, or Roth conversion), pension or Social Security income, additional wage income or a bonus, etc.

Planning Implications of the Medicare Contribution Tax

Broadly speaking, the planning implications for the coming Medicare contribution tax include both the steps that clients and planners may take to mitigate or avoid the tax, and the impact to financial decisions that may occur because the tax is present.

With respect to steps to mitigate or avoid the tax, there are two primary techniques that emerge: reducing investment income, or reducing MAGI and managing the crossover zone. We will look at each of these in turn.

Figure 3. Illustration of investor on the edge of the Medicare tax crossover zone.



Reducing "Net Investment Income"

To the extent that the Medicare contributions tax only applies to "net investment income" (once it falls above the threshold level), steps which reduce the amount of net investment income subject to the tax will serve to avoid the tax. Minimizing net investment income may potentially take many forms, though, depending on whether it is viewed from a short- or long-term time horizon.

In the short-term, steps to take might include focusing on non-taxable investment options (e.g., tax-exempt municipal bonds) which don't increase net investment income - or viewed another way, re-evaluate the prospects for tax-exempt bonds bearing in mind that the client's tax rate may be higher (due to the 3.8% tax), and adjust accordingly when evaluating the tax-equivalent yield. Maximizing deductions that can be taken in the current year will also be helpful; although not many deductions are commonly available for typical portfolio investment income purposes, clients with passive investment income (e.g., from real estate) may find it all the more valuable to ensure all available deductions associated with that passive business are claimed, given the higher tax rate, and perhaps even to try to time them in years with the most Medicare contribution tax exposure.

Alternatively, in the case of investments like real estate, some commentators have suggested that investors may seek to compensate for the tax by increasing their income in the first place - in other words, by raising their rents to bring in additional income to help compensate for the amount of tax (of course, the additional income itself would also potentially be subject to the 3.8% tax rate, but the landlord still retains the other 96.2% of the extra rental income!). On the other hand, many real estate investors may face little or no Medicare contributions tax associated with their rental income, because the tax only applies to *net* investment income (not gross rents), which means that depreciation deductions alone may substantively offset much or all of the taxable income from real estate (and thus the associated Medicare contribution tax). However, it is important to note that in this situation, any gains ultimately recognized on the sale of the property (including, ostensibly, from depreciation recapture) may be subject to the Medicare contribution tax at that time, which means the depreciation deductions may have deferred the tax but not necessarily avoided it completely. Another potential way to "avoid" the Medicare contribution tax on passive income is to render the income active instead - i.e., to "materially

participate" in the business under the tax code rules that divide passive from active income. However, while active participation may avoid the 3.8% Medicare contributions tax on the business income, it can subject the business income to self-employment taxes, which may not necessarily be a net positive in many cases!

From the longer-term perspective, reducing investment income for Medicare contribution tax purposes can be facilitated by deferring or accelerating it into years where the investment income will not be over the applicable threshold (thereby avoiding the tax). For instance, a retired client faces ongoing pension and Social Security income of \$140,000/year, and has \$60,000/year of net investment income. However, in a few years the client will begin to receive \$80,000/year of RMDs, forcing his MAGI up to \$280,000/year from the current \$200,000, which will cause all of the \$60,000/year of net investment income to face the 3.8% Medicare contribution tax, as the RMD income falls in the crossover zone. To avoid this impact, the client might consider converting some or all of the IRA to a Roth IRA over the next 3 years, so that there are little or no RMDs that will occur by 2013 when the Medicare contribution tax takes effect. Of course, the client should still be cautious in doing the Roth conversion, not to face an even higher tax rate now (via a large conversion) than what will be paid in a few years through ordinary income plus the 3.8% Medicare tax. Nonetheless, the general principle remains the same - Roth conversions afford a way to accelerate income in non-Medicare-tax years to avoid exposure in future years.

Conversely, tax-deferred annuities may be appealing to accomplish the same task, by deferring income in "current" years beginning in 2013 (where it may face Medicare tax exposure due to the combination of investment income and wage income) out to future retirement years where "just" the client's retirement income will be low enough to fall below the Medicare contribution tax threshold. On the other hand, use of annuities in such a manner may not be appealing if the *only* thing avoided is the Medicare contribution tax; clients who choose to pay ongoing annuity and mortality expenses of 0.5%, 1%, 1.5%, or more, *each year*, accumulating for extended periods of time, will not benefit if the only value is avoiding a one-time 3.8% tax on the growth. The effect is even more severe given that the annuity costs are paid on the *entire* balance of the contract, while the 3.8% Medicare tax applies only to the *growth*. This does not necessarily mean that annuities shouldn't be used for clients; however, it does suggest that an extended use of annuities solely for tax deferral and shifting income to non-Medicare-tax years

may still be a losing proposition if the ongoing annuity expenses ultimately overwhelm that value.

Alternatively, investment income may also be reduced by converting the income into a tax status that will not be subject to the Medicare contribution tax in the future. Most obviously, this involves steps like contributing to a tax-free Roth IRA (where growth is not taxed inside the Roth IRA, and withdrawals are not taxed {if qualifying}), such that the Medicare contribution tax (and any tax) on the growth is avoided completely. Investment vehicles like 529 savings accounts, Coverdell Education Savings Accounts, and Health Savings Accounts would also fall into this category. Depending on the ultimate outcome for the treatment of deferred compensation (i.e., whether it too is excluded entirely from the definition of net investment income), use of such plans for high income/high wealth employees may also be very desirable, to avoid what otherwise might be Medicare contribution taxes on the ongoing growth of the employee's portfolio income, had the compensation been paid outright and just invested in a taxable account.

Similarly, use of traditional pre-tax retirement accounts also affords a unique opportunity for managing the Medicare contribution tax, since retirement account distributions are explicitly (under the tax code itself) excluded from net investment income when withdrawn for the purposes of the tax. Not only does this provide yet another incentive for the pre-tax retirement account - that outside investments are subject to yet another 3.8% tax if the taxpayer's income is high enough - but it also creates the possibility of converting an investment from being subject to the tax to an identical investment that avoids it. For example, if the client already owned a \$5,000 CD generating interest - which will be subject to the Medicare tax if MAGI is high enough - the client can contribute to a traditional IRA, own the same \$5,000 CD, yet the growth and subsequent withdrawals will not be subject to the Medicare tax (because they are treated first and foremost as IRA withdrawals). Notably, this advantage occurs even if the IRA contribution was non-deductible; in such a case, only the growth is taxable (but it would have been anyway) at ordinary income rates (which it would have been anyway) but without the Medicare tax. Of course, the relative value of IRAs may be limited, given

the size of contribution limits, when the income level for the Medicare contribution tax is so high - i.e., how helpful is it "really" to make another \$5,000 IRA contribution when you only face the Medicare contributions tax with income in excess of \$200,000 or \$250,000 per year. Nonetheless, the IRA still helps to create some value by avoiding the Medicare contribution tax on all future growth.

A potential hybrid version of the preceding approaches is the use of life insurance as a partial accumulation vehicle to avoid the impact of the Medicare contribution tax. Growth in a life insurance policy is tax-deferred, thereby avoiding the impact of the Medicare tax, and the possibility to extract money from the policy via both principal-first withdrawals and through loans represents a chance to completely avoid the impact of the Medicare tax on growth. Of course, the caveat is that the policy must remain in force until it matures as a (tax-free and therefore Medicare tax-free) death benefit to harvest this value; if the policy ever lapses, such that gains must be recognized, Medicare contribution tax may come due in full force on the policy's growth (and would perhaps be even more likely to, given that all of the growth would be recognized in a single tax year, increasing the possibility that some or all of the income will fall above the applicable threshold). In addition, clients should be cautious about using life insurance for this purpose if the sole goal is to avoid the Medicare contribution tax; in the end, the tax *is* only 3.8% *of the growth*, and ongoing expenses of life insurance can far exceed that, in a manner similar to the annuities. Thus, for example, if the client had an investment option available that would growth at 8%, the after-tax growth rate accounting for the impact of the Medicare contribution tax would still be 7.7% (of course, other taxes may apply as well). Thus, taking on a policy that has internal policy expenses of 1%, 2%, or more, reducing growth rates to 7%, 6%, or less, would represent a significant *loss* of wealth, relative to just paying the 3.8% tax rate on the growth that would still yield the equivalent of a 7.7% net growth rate in the first place. In addition, it's even worse given that such fees may apply to the *entire* value of the policy. For example, a client who has \$100,000 of principal in a

variable policy that earns \$8,000 (8%) of growth, might pay annual fees and expenses of 1% (which would be \$1,080) or 2% (or \$2,160) just to avoid a tax of 3.8% on the \$8,000 of growth (which would have only been \$304 of taxes in the first place). As in the case of annuities, there

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may be other reasons to consider life insurance (or annuities) where the total benefits are desirable relative to the costs; the point is simply that for the purposes of managing/avoiding the Medicare contribution tax alone, the costs would appear to far outweigh the tax benefit.

Reducing MAGI and Managing the Crossover Zone

An alternative approach to reducing exposure to the Medicare contribution tax is to reduce MAGI instead, and manage the crossover zone. As discussed earlier, to the extent MAGI is low enough that it does not exceed the applicable threshold, no Medicare contribution tax can be due. Alternatively, if income is so high that other (non-investment income) exceeds the applicable threshold, then all net investment income will fall above the threshold and be fully subject to the Medicare contribution tax. However, between those two points is the possibility that some net investment income may fall above the threshold while the rest falls below it; at that point, any changes at the margin to MAGI can directly reduce exposure to the Medicare contribution tax, even if they are changes to *non*-investment income. The following examples, exploring the impact of a \$25,000 reduction in non-investment income (and thus, MAGI as well), can help to illustrate this further.

John has \$40,000 of net investment income, and \$140,000 of other income. Accordingly, his MAGI would be \$180,000, which is below the \$200,000 applicable threshold. As a result, John will not be subject to the Medicare contributions tax, and even if he reduces his MAGI by \$25,000, there will be no effect on that particular tax (because it is already \$0).

Harold and Joan have \$75,000 of net investment income, in addition to \$325,000 of other income. Their MAGI totals \$400,000, which puts them \$150,000 over the \$250,000 applicable threshold amount for married couples. Since the Medicare contribution tax is due on the lesser of net investment income (\$75,000) or the excess of MAGI over the threshold ($\$400,000 - \$250,000 = \$150,000$), the couple will owe the Medicare contributions tax of 3.8% on all \$75,000 of their net investment income. If Harold and Joan reduce their income by \$25,000, they will still be subject to the Medicare contributions tax on the full \$75,000 of net investment income; again, as a result, reducing MAGI still does not necessarily result in any Medicare contribution tax savings. In order to create any savings, they would need to reduce

their income at least down to the crossover zone, as shown further in the additional examples below. Consequently, for Harold and Joan, their only Medicare contribution tax savings opportunity is to reduce their net investment income, either permanently, or by shifting it to a future their when their other income may be low enough to cause any net investment income to fall below the threshold.

Morris and Judith have \$50,000 of net investment income, and \$240,000 of other income. Their MAGI adds up to \$290,000, which puts them \$40,000 over their applicable threshold amount of \$250,000. Accordingly, they will be subject to the Medicare contribution tax on the last \$40,000 of their net investment income. If Morris and Judith can reduce their income by \$25,000, bringing their MAGI down accordingly, then (unlike the preceding examples) their exposure to the Medicare contributions tax will also be reduced by \$25,000; with a new MAGI of only \$265,000, their excess above the threshold would be only \$15,000 (instead of \$40,000), allowing them to avoid \$950 of tax (3.8% on the last \$25,000 of income that now falls below the threshold). Notably, because they are in the crossover zone, Morris and Judith only need to reduce their income by \$40,000 to completely eliminate their Medicare contributions tax exposure; they do *not* need to reduce their net investment income all the way to \$0 to achieve that result. Or viewed another way, any income reductions that are greater than \$40,000 will have no further benefit (from a Medicare contributions tax perspective), because their Medicare contribution tax liability will already be reduced to \$0 by bringing total MAGI under the threshold amount. It is important to bear in mind that because they face the crossover zone, this Medicare tax savings can be produced either by reducing net investment income, *or* any *other* income, to achieve the same result.

Trevor and Maria have \$100,000 of net investment income, and \$300,000 of other income. Their MAGI is \$400,000, with an excess of \$150,000 over their applicable threshold amount. As a result, their entire \$100,000 of net investment income will be subject to the Medicare contribution tax, in a similar manner to the example of Harold and Joan earlier. As in the case of Harold and Joan, a \$25,000 reduction in their other income will result in no net savings for the Medicare contribution tax, because their MAGI excess over the threshold amount would still be \$125,000, which means their entire \$100,000 of net investment income is still subject to the tax. However, a different result occurs if Trevor and Maria instead can reduce their other income by \$75,000. In this case, the first \$50,000 of income

reduction simply brings their other income down to the point that they *reach* the crossover zone; the next \$25,000 actually pulls a portion of their net investment income below the applicable threshold, though, resulting in an outright savings of Medicare contribution tax. Notably, this result is only achieved by reducing their income enough to even *reach* the crossover zone, such that further income reductions actually pull net investment income down and out of the taxable range.

Of course, this exploration of how reducing MAGI to manage the crossover zone doesn't address how to actually accomplish a reduction in MAGI itself. Broadly speaking, there are only two primary ways to reduce income in this manner: 1) to increase deductions which reduce MAGI; or 2) to change the timing of income (deferral or acceleration) from the year the client wishes to reduce MAGI to a year where it won't have such an adverse effect. (Of course, there is always a third option to reduce MAGI - which is simply to earn less income in the first place; however, forfeiting \$1 of income to save 3.8 cents of tax is not exactly a wealth-building strategy!)

Increasing Deductions which Reduce MAGI

Because the Medicare contribution tax is determined based on AGI (or rather, MAGI) exceeding the applicable threshold amount, only so-called "above-the-line" deductions that reduce AGI/MAGI are helpful for reducing exposure to the tax. Below-the-line deductions - i.e., any of the numerous itemized deductions available to most clients - are subtracted from AGI to determine taxable income, and consequently produce no savings for Medicare contribution tax purposes.

Nonetheless, any above-the-line deduction is potentially available to reduce MAGI for the purposes of saving Medicare contribution tax through the crossover zone. In practice, though, a relatively few number of deductions are available that have the flexibility to be utilized whenever the client wishes (or timed for a year where the crossover

zone is relevant). Some of these include (to the extent allowable):

- Capital losses
- Business losses

Of course, other deductions against income can reduce AGI as well, such as deductions for one half of self-employment taxes, self-employed health insurance, student loan interest, etc. However, such deductions typically occur for other business or personal reasons, and are not necessarily as "flexible" to be timed simply for the purposes of managing MAGI for the Medicare contribution tax.

Shifting the Timing of Income

While the aforementioned above-the-line deductions are outright reductions in AGI (as they generally represent outright economic/wealth losses), other deductions can be helpful not because they permanently reduce income, but because they cause a shift in the timing of income.

For instance, choosing to complete a Roth conversion allows a client to accelerate income into the current year, to avoid facing income in future years. Although a full discussion of the benefits and risks of Roth conversions is beyond the scope of this issue (for further information, see the May 2009 issue of *The Kitces Report*, "To Roth or Not To Roth" - email michael@kitces.com to request a copy), from the Medicare contribution tax perspective a Roth conversion can be valuable by accelerating income into a year where the client is outside the crossover zone (either by being so far below that a Roth conversion

won't cause them to reach the zone, or by being so far above the zone that all net investment income is already taxed and there is no further impact). If the income acceleration moves the income into a year where the client is *not* subject to the tax, and causes it to not be recognized in the future where the client *is* facing the tax (e.g., when significant Required Minimum Distributions begin after age 70 1/2 if the client has a very large retirement account), then a portion of the Medicare contribution tax

Out and About

- Michael will be speaking on "Market Valuation and Safe Withdrawal Rates" at the FPA Central Virginia Financial Forum in Richmond, VA on May 6th
 - Michael will be presenting on "Advanced Concepts in Long-Term Care Insurance" on May 18th for FPA Philadelphia
 - Michael will also be presenting on "Rethinking Risk Tolerance" at the FPA Miami-Dade meeting on May 19th
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may be avoided. It is notable that given the pending changes in income tax rates in the coming years (due to lapsing tax legislation), it may be especially desirable for clients to consider Roth conversions in the 2010 tax year, if otherwise appropriate.

Similar to completing Roth conversions to accelerate income, a decision to contribute to a retirement account can also benefit by deferring income, bringing it down (if the client is already in the crossover zone) in the current year and reducing exposure to the Medicare contribution tax (with the hopes that it will be recognized in a future year where the client won't be in the crossover zone). Technically, a deductible (i.e., pre-tax) retirement account contribution only results in income shifting (since the contribution, plus growth, must eventually be recognized at some point in the future when withdrawn), but may still be helpful if it shifting favorably affects the Medicare contribution tax crossover zone. For example, if the client makes contributions when current income is high (due to significant employment income) and there is Medicare contributions tax exposure, and takes withdrawals after retirement when income is much lower (and well below the applicable threshold), the client may avoid ever paying the tax on a portion of income. Notably, while the retirement account contribution itself merely *shifts* income (from the year contributed/deducted to the year withdrawn/recognized), the Medicare contributions tax may represent *permanent* tax savings (i.e., with favorable timing, the tax is never paid in the year of contribution, nor the year of withdrawal). In addition, growth on the retirement contribution itself will also never be recognized as net investment income for purposes of the tax, as discussed earlier, providing an additional benefit for the retirement contribution. This approach (and the Roth conversion strategy in the prior paragraph) may also benefit from income tax bracket rate changes as well, since obtaining deductions in high income years and deferring to low income years can produce ordinary income tax savings as well (and conversely, converting to a Roth IRA in low income years and avoiding recognition in higher tax years).

To the extent that the timing is flexible, a proactive approach to the timing of when losses are recognized - e.g., capital losses, business losses, or even other types of business deductions - may also yield favorable Medicare contribution tax savings by managing around the crossover zone. Similarly, restructuring the recognition of significant income events - e.g., completing a business or real estate sale as an installment note rather than a lump sum sale, to spread

income out and maintain it below the applicable threshold over the span of several years, may also be beneficial.

Bringing It All Together

To evaluate what clients should be focused on for some of the planning techniques discussed in this newsletter, it may be helpful to consider these strategies in light of which clients are likely to be affected by the new Medicare contribution tax.

Who Is Likely Affected

First and foremost, it's important to note that, as discussed earlier, the Medicare contribution tax cannot apply to a client unless he/she/they have (modified) Adjusted Gross Income in excess of the applicable thresholds of \$200,000 (for singles) and \$250,000 (for married couples filing jointly). These income thresholds are not trivial amounts for the clients of many financial planners.

Consequently, the reality is that many clients will have little or no exposure to the Medicare contribution tax on an ongoing basis. Or alternatively, their only exposure arises when they have a significant income event that causes income to (temporarily) rise above the threshold for a single year. Major income events that can trigger this might include significant employment bonuses, a major sale of investments or a business, exercise of (non-qualified) stock options, or a Roth conversion. For clients in this category, planning will likely be focused on timing strategies to reduce MAGI if the client's "sudden income" puts him/her near the crossover zone. If the income event pushes them significantly beyond the applicable threshold, though, only steps to outright reduce net investment income will be effective.

For clients to be exposed to the Medicare contribution tax on an ongoing basis, they must have significant ongoing income. This may come in several forms. For retired clients, the greatest exposure comes from clients who outright have very significant wealth (e.g., at least "several" million dollars) - which means the "passive" interest, dividends, and capital gains that inevitably occur periodically within the portfolio are enough to push MAGI up and over the applicable threshold. Retired clients over age 70 1/2 may face ongoing exposure due to Required Minimum Distributions if the overall size of the IRA (and therefore the RMDs) is worth at least several million dollars. Alternatively, exposure may also be present for clients aged 59 1/2 to

70 1/2 who have such substantive IRAs if they must take significant (taxable) withdrawals from the accounts on an ongoing basis to fund their retirement lifestyle. Extremely large pensions, or a multi-year period of deferred compensation payments, may also push other income high enough that net investment income faces the Medicare contribution tax. For clients at this income level, the focus is likely to shift to reducing net investment income, as a strong "base" of other income pushing them up past the applicable threshold is, by definition, income that they cannot likely shift the timing of. Clients who find themselves falling right in the crossover zone may still create some value by seeking to shift income to the extent possible, even if it is just to shift income out of a year in the crossover zone and into a year where income is *higher*, such that all net investment income is already taxed and there is no further "harm" by shifting additional income into that tax year (assuming there is not an adverse change in marginal tax bracket rates).

However, the Medicare contribution tax does not only involve retired clients. In point of fact, the clients who may struggle the most with the tax are those who are currently working and employed in high-paying jobs as professionals or business owners. Clients with significant ongoing income from business or employment - filling other income up to or beyond the applicable threshold amount - may consequently face the Medicare contribution tax on all of their net investment income. In the case of clients who are earlier in the accumulation phase, this tax exposure may not necessarily be significant, only because the portfolio itself may not be significant. However, clients in their 50s and 60s - often approaching retirement with a significant portfolio producing investment income while also in their peak earning years - may be particularly at risk. For clients whose employment income alone drives them far above the applicable threshold, steps to reduce net investment income may be the only option to help mitigate the Medicare contribution tax. If clients are close enough to the crossover zone, shifting income (especially to the ostensibly-lower-income retirement years) may be desirable. Clients in this category may find retirement accounts especially appealing (although one would hope they are saving already!), as such contributions have the potential to avoid current Medicare contributions tax if the client is in the crossover zone, and shift income to future years when tax rates are lower, and avoid future Medicare contributions tax on the growth due to the treatment of retirement accounts. Other forms of deferred compensation may also be appealing, if available through the employer.

It is also important to note that even where clients have "low" income and no apparent exposure to the Medicare contribution tax, planning opportunities may exist, if there is a possibility that the client will be subject to the tax in the future. In point of fact, client situations of "low income now, high income in the future" are beneficial not only to shift the timing of income into the current low income years to avoid future Medicare tax exposure (e.g., by doing a Roth conversion), it is also beneficial simply to recognize income in the current year and reduce it from a future year to take advantage of differences in the marginal tax brackets. In practice, this means that clients who do not face the Medicare contribution tax now, but fear or anticipate that they might in the future, will simply find income shifting (i.e., income acceleration) tax planning techniques to be even more advantageous than they already would have been.

Other Issues

Beyond the general planning techniques discussed previously, a few other planning opportunities are worth noting as well.

With respect to trusts, clients will now need to consider even more carefully the benefits of having trusts accumulate income versus distributing it, given that it will take only a very modest amount of total trust income for the trust to face the 3.8% Medicare contribution tax. Of course, in many situations, trusts are used as accumulation vehicles for asset protection and/or spendthrift concerns, where paying "just" another 3.8% tax rate on the trust's income is worthwhile relative to protecting the trust's income and principal. However, in some situations where there is reasonably more discretion regarding the trust's income (either by the client in creating the trust, or the trustee in managing the distributions of the trust), a fresh look at whether the trust should retain or distribute income in 2013 and beyond may be worthwhile. Controlling the nature of the trust's investments and their propensity to produce taxable income may also be slightly more appealing.

It is also notable that several additional planning techniques will likely emerge in 2012 in particular, to plan for the then-near-term implementation of the tax. This may include establishing trusts later in the 2012 calendar year, such that some or all of the 2013 *calendar year* will still fall in the 2012 *tax year*, allowing at least a few months of 2013 income to avoid the Medicare contribution tax (since the tax only applies to income from *tax years beginning after December 31, 2012*). For individuals, it may be desirable to accelerate and recognize certain investment income in 2012

(especially if it was going to otherwise be recognized in 2013 anyway), if the client would otherwise face the Medicare tax in 2013. This might include selling bonds with accrued interest late in 2012 so the bond income is recognized before the new tax takes affect; in some cases, it may even be desirable to accelerate capital gains into 2012 if they would otherwise face the Medicare tax in 2013.

A Word of Caution

Notwithstanding the previous discussion of this entire newsletter regarding planning for and around the new Medicare contribution tax on unearned income, a word of caution about such planning techniques is merited. The caveat, simply put, is that in the end the new tax *is* assessed at a rate of only 3.8%, and is only on the growth (i.e., income) associated with investments. For a \$100,000 investment earning an 8% growth rate, this amounts to a tax of 3.8% on \$8,000 of growth, or \$304 of tax on a \$100,000 account (a net impact of 0.304%).

Accordingly, changing investments in a manner that reduces the expected return by more than 0.304% (assuming an 8% return base) can result in less wealth than just earning growth and paying the tax on that growth. This may be relevant both in the context of evaluating the benefits of annuities and life insurance for the purposes of avoiding the tax (as discussed earlier), or making other investment changes to the portfolio (e.g., harvesting a loss and buying a not-substantially-identical security to avoid the wash sale rules, and having the new investment trail the old investment by more than a 0.3% return difference). Alternatively, the difference in fund expenses alone amongst many mutual funds can overwhelm the tax savings associated with actively planning.

Similarly, income shifting techniques can unintentionally cause income to fall in tax brackets, and the rate differential can more than overwhelm the benefit of planning around the Medicare tax. For example, a large Roth conversion might help to avoid the Medicare contributions tax in the future by reducing future MAGI, but if the conversion shifts money into a current 35% tax bracket when it would have faced only a 28% future tax bracket, the client may lose more in ordinary income tax rates (a 7% increase in tax rates) than is gained by avoiding the Medicare tax (only a 3.8% tax rate savings).

Alternatively, the difference could also simply come from a change in circumstances; for example, the client who accelerates income to avoid the Medicare

contribution tax in the future, but also planned to move from a high income tax state to a low income tax state at retirement (e.g., moving to Florida). In such a scenario, the client might have avoided a future tax of 3.8% on net investment income, but in the process failed to take advantage of a situation where all income would have been taxed 5% to 9% lower in retirement, anyway, due to the change in states and their associated state tax rates!

Summary/Conclusion

In the end, the Medicare contribution tax will present a new area of planning, especially for clients who currently have high income and face the tax when it takes effect in 2013, but also for those who may be subject to the tax intermittently in high income years, or in the more distant future as wealth is accumulated and income rises.

In any event, it may (and hopefully will) be advantageous for clients to plan for and around the Medicare contribution tax. In this newsletter, we have explored how the tax is determined, and several approaches and techniques to help plan for and/or mitigate the impact of the tax. Nonetheless, it is still important to avoid giving up more from ordinary income tax rate changes than may be saved by Medicare contribution tax planning. Furthermore, be cautious not to let the tax tail wag the investment dog, making decisions that are favorable with respect to the Medicare contribution tax, but give up more in economic value and prospects for returns than is saved by the tax itself.

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