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Planning For The New 3.8% Medicare Tax on Unearned (Portfolio) Income

(Updated for December 2012 Treasury guidance)

- The new 3.8% Medicare tax on unearned income first takes effect in 2013, as a part of the Patient Protection and Affordable Care Act of 2010. It is accompanied by a separate 0.9% Medicare tax on earned (i.e., wages and self employment) income as well. The new 3.8% Medicare tax only applies to "high income" individuals, though, which is defined in the tax code as individuals with an AGI in excess of $200,000, or married couples above a $250,000 AGI. The tax also applies to trusts and estates, although the thresholds are dramatically lower (tied to the top tax bracket threshold, which is only $11,650 in 2012!); fortunately, for trusts and estates the tax only applies to income that is *not* distributed to beneficiaries.

- The new 3.8% Medicare tax applies only to "net investment income" that fall above the thresholds. Net investment income is defined broadly, though, and includes interest, dividends, annuities, rents, royalties, any income from a passive business, and any capital gain. However, several exceptions apply, such as income that is otherwise excluded or exempt is not included as "net investment income" for the purposes of the 3.8% Medicare tax, or any income attributable to a withdrawal from a qualified retirement account.

- Notably, income that increases AGI can still cause (other) investment income to become subject to the new Medicare unearned income tax, even if that income is not treated as net investment income. This is called the "Medicare Tax Crossover Zone" and applies to individuals who currently have some but not all of their investment income subject to the new Medicare tax.

- Evaluating potential client exposure to the new 3.8% Medicare tax involves first determining whether the client is likely to reach or exceed the income thresholds, and then evaluating whether or how much net investment income the client has. If both tests are met, then the client likely has some exposure to the new tax, and planning can begin accordingly.

- Planning strategies to manage the new 3.8% Medicare tax depend on how exposed the client is to the tax. For those with lower income, who are only subject to the tax in "big income" years, effective planning simply involves trying to manage for and around the occasional high income years.

- Clients with high income and ongoing exposure to the tax – whether retirees receiving big pensions or taking big voluntary or required distributions from retirement accounts, or workers in their peak earning years – will likely focus primarily on reducing net investment income. This may include sheltering the income in tax-exempt or retirement accounts, shifting to tax-exempt investments like municipal bonds, or taking advantage of permissible deductions to reduce investment income.

- Clients with occasional exposure to the tax will more likely focus on managing the 3.8% Medicare tax crossover zone, and utilize strategies that shift the timing of income to manage the tax. Income shifting strategies might include strategic timing of business or capital loss deductions (to the extent permitted by the tax code), or accelerating or deferring income to try to time it in years where the client's AGI will be below the applicable thresholds.

- Notwithstanding the value of planning for the new 3.8% Medicare tax, it's important to bear in mind that it is only a 3.8% tax. As a result, be cautious not to let the tax tail wag the investment dog – i.e., selecting investments that may have greater economic costs than the potential benefit of the Medicare tax savings.

About the Author

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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, and partially shore up Medicare shortfalls, 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.

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 (as clarified by Treasury regulations issued in December 2012, for further information see http://bit.ly/UpdatedMedicareTaxRegs); although it is similar to net investment income used in the context of determining the amount of investment expenses that can be deducted, the rules are somewhat 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.

Notably, annuity income for these purposes includes both withdrawals from deferred annuities, and payments from annuitized contracts; however, these rules apply only to non-qualified annuities, and only amounts actually reported in income for regular tax purposes are treated as income for the 3.8% Medicare tax.

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 amount of qualifying capital gains from the sale of a principal residence, etc.). Similarly, gains that are deferred due to non-recognition rules – e.g., 1031 exchanges for real estate or 1035 exchanges for non-qualified annuities – are not included in investment income for the purposes of the 3.8% Medicare tax (although ultimately will be reported as net investment income when liquidated in the future).

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 unearned income 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 business in which the taxpayer materially participates will not be subject to the 3.8% Medicare unearned income tax. Notably, this suggests that income from partnerships, LLCs, and S corporation dividends may or may not be subject to the new 3.8% Medicare tax, depending on whether the individual is an active participant in the business. (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, regardless of whether or not there is material participation.)

On the other hand, gains from the sale of a partnership, LLC, or S corporation business will only be treated as net gain for the purposes of the 3.8% Medicare 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. In other words, gains for the sale of a business are only taxed if they represent gains from the sale of the business' underlying property; gains associated with goodwill, on the other hand, would escape the 3.8% Medicare tax.

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 3.8% Medicare unearned income tax (although it may well be subject to the new 0.9% Medicare tax on *earned* income!).

The new rules also explicitly state that any distributions from a qualifying 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 such as 401(k) plans and pension 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)

Notably, non-qualified deferred compensation would also appear not be subject to the 3.8% Medicare tax, but only because such income that has not yet vested will ultimately become subject to the 0.9% Medicare tax on *earned* income in the future (and once received, will then become subject to the 3.8% Medicare tax).

Ultimately, *net* investment income is determined by applying deductions against such income. According to the Treasury guidance issued in December 2012, such deductions are limited by the rules that otherwise apply under the tax code. Thus, for instance, to the extent investment interest deductions are limited for regular tax purposes, the deduction is similarly limited for the 3.8% Medicare tax; constraints on passive losses and capital losses also apply when determining net investment income. On the plus side, the guidance also affirmed that carryforward losses held in abeyance (except for business Net Operating Loss carryforwards) can still be used to reduce net investment income in 2013 and beyond, even if the loss originated in a prior year before the tax applied.

Modified Adjusted Gross Income

As indicated earlier, the second test for determining the amount of income subject to the Medicare unearned income 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).

Which means for financial planners whose clients are not expatriates, “modified AGI” simply means AGI as normally reported on the tax return.

Applicable Threshold Amount

In order to evaluate how much MAGI exceeds the applicable threshold amount, it is also necessary to define what “threshold amounts” means. 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.)

Notably, these threshold amounts above are *not* indexed for inflation, which means over time more clients will become subject to the 3.8% Medicare tax as inflation lifts income and net worth.

Applying the Rules

As stated earlier, the 3.8% Medicare unearned income 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).

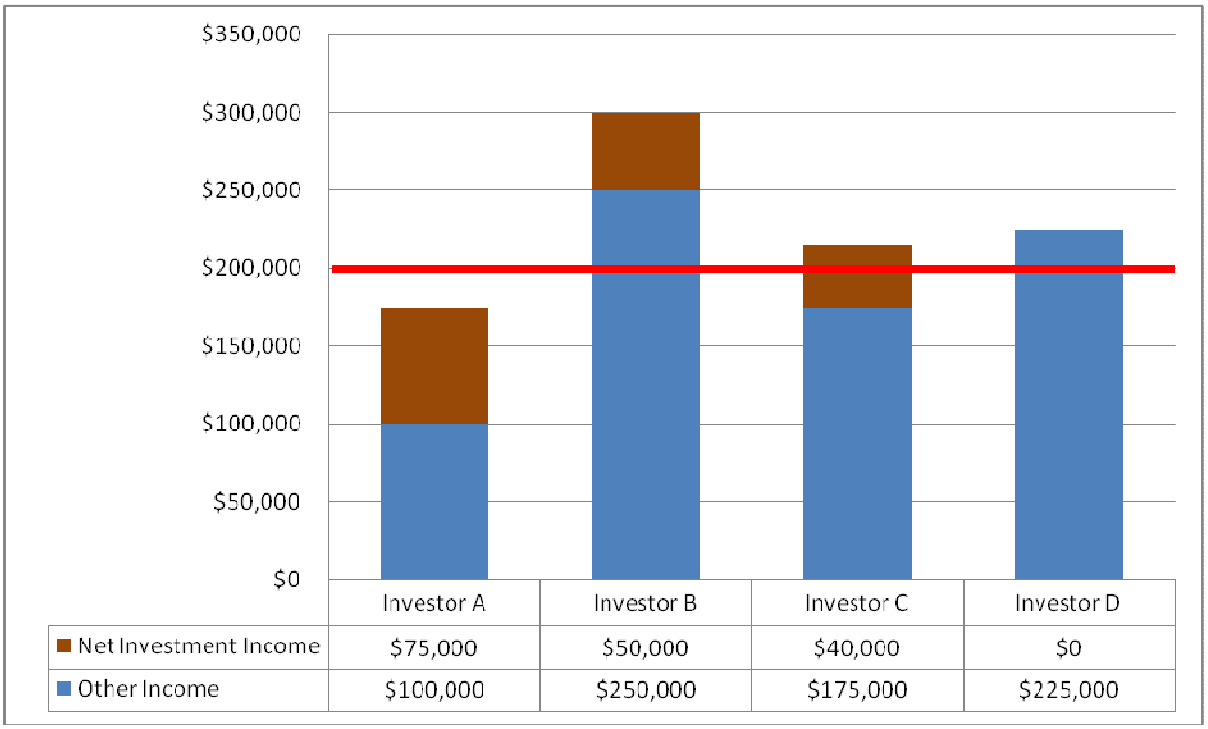
In the case of investor A, the investor's total MAGI would be a total of $175,000, which is below the $200,000 applicable threshold amount; consequently, the excess of MAGI above the threshold is $0, the lesser of net investment income ($75,000) or amount above the threshold ($0) comes out to be $0, 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 ($50,000) or the excess of MAGI over the threshold ($100,000), investor B owes the new 3.8% Medicare tax on all $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

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



exceeds the applicable threshold amount by $25,000, there will be no Medicare contributions tax due, because net investment income is $0 (if there's no investment income, there's nothing for the 3.8% Medicare tax to apply towards!). 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). On the other hand, it's notable that if the blue box of $225,000 was all earned (employment or self-employment) income, the excess above $200,000 may still be subject to the new 0.9% Medicare tax on earned income.

Evaluating Potential Exposure

These examples can be boiled down to a relatively straightforward framework for quickly evaluating 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 unearned income 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 3.8% Medicare tax. Furthermore, to the extent the client is never anticipated to exceed those thresholds in the foreseeable future, the tax continues to be a moot point; for clients materially below the threshold, they only ever need worry about the tax if they anticipate an income spike that could force them above the threshold at some point in the future.

What About Trusts?

In the case of trusts (and estates), the 3.8% Medicare tax on unearned income 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 $11,650 in 2012 (and adjusted slightly higher for inflation in 2013).

This threshold amount for trusts and estates is dramatically lower than that which applies to individuals, and means that trusts which retain income may actually be at far greater exposure risk to the 3.8% Medicare unearned income tax than individuals are. As a small consolation, though, unlike the other applicable threshold amounts, this threshold will inherently be indexed for inflation (albeit from a *much* lower base), because it is based on the tax brackets that are adjusted annually for inflation.

Another notable difference in the Medicare unearned income 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 3.8% Medicare tax because its AGI exceeds the threshold amount, it can avoid owing the tax 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 3.8% Medicare 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 amounts. 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 3.8% Medicare 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 subsequent estate tax exposure for the beneficiary).

Notwithstanding the above provisions, IRC Section 1411(e)(2) explicitly excludes from the 3.8% Medicare tax for any tax-exempt trusts under IRC Section 501, charitable remainder trusts, and trusts that are entirely for the benefit of public charities/charitable purposes (although the distributions *from* such trusts to beneficiaries may still result in investment income subject to the 3.8% Medicare tax for the beneficiary).

In addition, it is also notable that if the trust is a grantor trust, the tax will 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 3.8% Medicare 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 whatever other taxes may apply to the income. Thus, capital gains are subject to the capital gains tax rate, *plus* 3.8%; qualified dividends are subject to the dividend tax rate, *plus* 3.8%; etc.

Of course, long-term capital gains tax rates, qualified dividend rates, and ordinary income brackets, have themselves been in flux and a state of uncertainty for much of the time since 2010 when the new Medicare tax was passed into law with a 2013 effective date. Notwithstanding this, many planners and their clients looked to harvest income in 2012, before the new tax took effect, to reduce future exposure to it (especially through the harvesting of capital gains).

Medicare Tax Crossover Zone

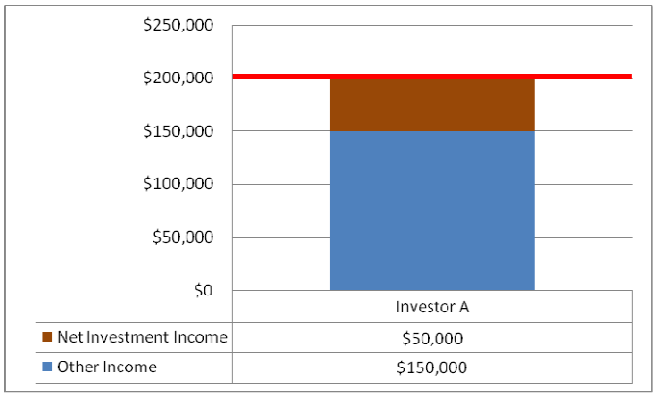
One significant problem that arises when planning and evaluating for the impact of the Medicare contributions tax is the so-called "crossover zone" where net investment income begins to push above the applicable threshold line, causing an increasing amount of investment income to be subject to the tax, 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 $50,000 of net investment income. Under the Medicare contributions tax rules, John will not owe any of the tax, because his MAGI would be right *at* $200,000, but there is no income above the $200,000 threshold. If John took a $20,000 capital gain, the last $20,000 of investment income would fall above the threshold, and it is investment income – which means it will be subject to the 3.8% Medicare tax.

However, let's now look at the impact when John receives a $20,000 salary bonus instead. His "other" income rises to $170,000, and when combined with his $50,000 of net investment income, his MAGI grows to $220,000, which is $20,000 in excess of the applicable threshold. Consequently, John will owe an extra 3.8% Medicare contributions tax on the last $20,000 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 2 (below) 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" (i.e., blue box) income will push an equal amount of net investment income above the threshold, causing it to become subject to the 3.8% Medicare tax. Graphically, this crossover zone continues to apply until the blue box (other income) has completely pushed all of the brown box (net investment income) up over the red line (applicable threshold).

Figure 2. Illustration of Medicare tax crossover zone.



For those who don't have enough income to reach the threshold in the first place, 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 blue box income results - at the margin - in a 3.8% Medicare contributions tax, even if that income itself is not otherwise subject to the tax.

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.

> *Example 1*. 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 3.8% Medicare tax on any of his investment income, and even if he reduces his MAGI by $25,000, there will be no effect on that particular tax (because it is already $0).
>
> *Example 2*. 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 3.8% Medicare 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 unearned income 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.
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> Consequently, for Harold and Joan, their only Medicare tax savings opportunity is to reduce their net investment income, either permanently, or by shifting it to the future when their other income may be low enough to cause any net investment income to fall below the threshold.

Example 3. 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 for married couples. 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 3.8% Medicare 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 their 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 3.8% Medicare 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 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.

Example 4. 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 3.8% Medicare 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.

Depending on the client circumstances, almost any form of additional or reduction in income could impact 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 3.8% Medicare unearned income 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.

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.

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 3.8% Medicare 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 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 3.8% Medicare 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 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! On the plus side, making income (or rather, losses) active also allows for better tax benefits associated with the losses, as passive losses may only be netted against passive income but active losses can offset more other types of income.

From the longer-term perspective, reducing investment income to reduce exposure to the 3.8% Medicare tax can be facilitated by deferring or accelerating income 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 $110,000/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 $250,000/year from the current $170,000, which will cause all of the $30,000/year of net investment income to face the 3.8% Medicare tax, as some of the RMD income falls in the

crossover zone. To avoid this impact, the client might consider converting some of the IRA to a Roth IRA over the next several years, so that any future RMDs are smaller and the client can more easily stay under the threshold. 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 provide 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 with reverse timing – deferring income from years where it is higher (e.g., due to ongoing employment), out to future retirement years where "just" the client's retirement income will be low enough to fall below the Medicare unearned income tax threshold. On the other hand, use of annuities in such a manner may not be appealing if the *only* thing avoided is the 3.8% Medicare tax; clients who choose to pay ongoing annuity and mortality expenses of 0.5%, 1%, 1.5%, or more, *each year*, on the *entire* value of the account for extended periods of time, will not benefit if the only value is avoiding a one-time 3.8% tax on just the growth portion. 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. On the other hand, if the annuity can be held long enough that cumulative tax deferral (or both ordinary income taxation and the 3.8% Medicare tax) it may still be worthwhile, and if the client's future tax rate is also lower, the positive wealth impact may be significant.

Alternatively, investment income may also be reduced by converting the income into a tax status that will not be subject to the 3.8% Medicare tax at all 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 3.8% Medicare 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. Nonqualified deferred compensation may also be appealing, as the 3.8% tax can be avoided during the accumulation years, although clients must be cautious that it does not drive up ordinary income tax rates too much at distribution time (which is true regardless of the 3.8% Medicare tax).

Similarly, use of traditional pre-tax retirement accounts also affords a unique opportunity for managing the 3.8% Medicare tax, since retirement account distributions are explicitly (under IRC Section 1411(c)(5)) excluded from net investment income when withdrawn. 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 subject to the same ordinary income tax rates, yet the growth and subsequent withdrawals will *not* be subject to the 3.8% Medicare tax.

In fact, the potential for IRAs to avoid the 3.8% Medicare tax even makes non-deductible IRA contributions more appealing; 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 the Medicare tax on the growth can be permanently avoided! Of course, the relative value of non-deductible IRAs is constrained, given the maximum contribution limits, especially when the income level for the 3.8% Medicare tax is so high in the first place; in other words, how helpful is it "really" to make another $5,000 IRA contribution and avoid tax on a few hundred dollars of growth every year if your income is already over $200,000/year? Nonetheless, the IRA – including non-deductible contributions – still helps to create some value by avoiding the 3.8% Medicare tax on all future growth, and may be especially appealing for investments that would have been subject to IRA-like ordinary income taxation anyway.

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 3.8% Medicare tax. Growth in a life insurance policy is tax-deferred, thereby avoiding the impact of the Medicare tax on

an ongoing basis, and the possibility to extract money from the policy via both principal-first withdrawals (for certain Universal Life policies) and through non-taxable loans represents a chance to completely avoid the impact of the 3.8% 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, the 3.8% Medicare tax can come due in full force on all of the policy's cumulative 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 tax; in the end, the tax *is* only 3.8% *of the growth*, and ongoing expenses on both the total cash value and death benefit amount at risk in a life insurance policy can far exceed that Medicare tax drag. Thus, for example, if the client had an investment option available that would grow at 8%, the after-tax growth rate accounting for the impact of the 3.8% Medicare contribution tax would still be 7.7% (of course, other taxes may apply as well). Thus, taking on an insurance 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 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 3.8% Medicare tax alone, the costs would appear to far outweigh the benefit.

Reducing MAGI and Managing the Crossover Zone

An alternative approach to reducing exposure to the 3.8% Medicare tax is to reduce MAGI instead, and manage the crossover zone, where some net investment income falls 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 3.8% Medicare tax, even if they are changes to *non*-investment income.

Broadly speaking, there are only two primary ways to reduce income to manage the crossover zone: 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 (or render the income tax-free so its timing doesn't matter at all). (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 3.8% Medicare 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 the purposes of the 3.8% Medicare tax.

Nonetheless, any above-the-line deduction is potentially available to reduce MAGI for the purposes of saving on the 3.8% Medicare 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). The most common would include, to the extent allowable, either capital losses (proactively harvested if necessary), or 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 unearned income 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 on retirement account withdrawals 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" or email michael@kitces.com to request a copy), from the perspective of the 3.8% Medicare tax, 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 3.8% Medicare tax may be permanently avoided through income shifting.

Similar to completing Roth conversions to accelerate income, a decision to contribute to a retirement account is also an income shifting strategy, deferring income from the year of contribution to the year of withdrawal. This, too, can help to avoid the 3.8% Medicare tax, especially if the client is already in the crossover zone – pushing the income down the road with the hopes that it will be recognized in a future year where the client won't be in the crossover zone. For instance, if the client makes contributions when current income is high (due to significant employment income) and there is exposure to the 3.8% Medicare tax, and takes withdrawals after retirement when income is much lower (and well below the applicable threshold for the Medicare tax), the client may avoid ever paying the tax on a portion of income. Thus, even though the retirement account contribution itself merely *shifts* income (from the year contributed/deducted to the year withdrawn/recognized), it may result in *permanent* tax savings from the 3.8% Medicare tax.

Notably, retirement account contributions may be especially appealing in this context, as not only does the contribution of *principal* help avoid the 3.8% Medicare tax via a deduction in the crossover zone, but in addition *growth* on the retirement contribution itself also avoids the tax (as retirement accounts are not counted as net investment income).

In some situations, it may be beneficial for clients to restructure significant income events if possible – e.g, completing a business or real estate sale as an installment note rather than a lump sum sale – to shift income or spread it out and maintain it below the applicable threshold over the span of several years.

Of course, the tailwind – or headwind – of these income-shifting approaches is that the client's ordinary income tax bracket may change as well. On the plus side, this may mean income is deferred or accelerated into a year with lower tax rates for the client's individual circumstances. On the other hand, it's important to remember that deferring or accelerating income into years with a higher tax bracket can partially or fully offset any Medicare tax savings!

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 3.8% Medicare tax.

Who Is Likely Affected

First and foremost, it's important to note that, as discussed earlier, the 3.8% Medicare 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 unearned income 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 (sizable) 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 the client significantly beyond the applicable threshold, though, only steps to outright reduce net investment income will be effective.

For clients to be exposed to the 3.8% Medicare 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 is at least several million dollars (resulting in RMDs that alone may push income up near the 3.8% Medicare tax thresholds).

Notably, large IRAs are not only a trigger for those past age 70 ½. Clients aged 59 ½ to 70 ½ who are funding retirement substantively from IRA withdrawals may already push income up near the 3.8% Medicare tax threshold, simply from spending withdrawals (regardless of whether the withdrawals were required by tax law). Similarly, extremely large pensions, or a multi-year period of deferred compensation payouts, may also push other income high enough that net investment income faces the Medicare unearned income tax. For clients at this income level, the focus is less on timing of income, and instead on reducing net investment income, as a strong "base" of ongoing income pushing the client up past the applicable threshold is, by definition, income that likely cannot be shifted effectively. Clients who find themselves falling right in the crossover zone may still find some tax savings benefits 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, ongoing exposure to the 3.8% Medicare 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 3.8% Medicare tax on any/all of their net investment income. In the case of clients who are earlier in the accumulation phase, this 3.8% Medicare tax exposure may not necessarily be significant, simply because the portfolio itself may not yet 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 unearned income 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 also retirement accounts especially appealing (although one would hope they are saving already!), as such contributions have the potential to permanently avoid the 3.8% Medicare tax by shifting income into retirement years (with the added benefit that rates may then be lower). 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 unearned income tax, planning opportunities may exist, if there is a possibility that the client will be subject to the tax in the future. With client scenarios that are "low income now, high income in the future" it is beneficial not only to shift the timing of income into the current low income years to avoid future 3.8% 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 unearned income 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.

Further Considerations for Trusts

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.

On the other hand, the reality is that many of these planning techniques and considerations for trusts have always been relevant, simply because of the compressed trust tax brackets in the first place, and making distributions to trust beneficiaries that spreads the income tax consequences amongst multiple beneficiaries with higher tax bracket thresholds has always been appealing. The addition of the 3.8% Medicare tax simply provides a small additional incentive to consider such strategies further.

A Word of Caution

Notwithstanding the previous discussion of this entire newsletter regarding planning for and around the new 3.8% Medicare 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 Medicare 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 deferring or 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 into different tax brackets, and the rate differential can more than overwhelm the benefit of planning around the 3.8% 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 3.8% Medicare 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 from Maryland 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 the tax rate in retirement was going to fall by 9 percentage points anyway, due to the change in states and their associated state tax rates!

Summary/Conclusion

In the end, the new 3.8% Medicare tax on unearned income will present a new area of planning, especially for clients who currently have high income and are facing the tax as 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 new 3.8% Medicare 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.

Notwithstanding the value of planning, though, it is still important to avoid giving up more from ordinary income tax rate changes than may be saved by avoiding the new Medicare tax in the first place. Furthermore, be cautious not to let the tax tail wag the investment dog, making decisions that are favorable with respect to the Medicare unearned income tax, but give up more in economic value and prospects for returns than is saved by the tax itself!

What did you think?

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