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UNDERSTANDING THE 3.8% MEDICARE SURTAX

Estate planning for unconventional families has never been more important. BY GARY ALTMAN, ESQ.

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

Application of surtax to individuals

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

Net Investment Income

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

- Dividends
- Rents
- Interest
- Capital Gains
- Royalties
- Passive activity income

"[T]axpayers must first understand what income (the surtax) applies to and how it is calculated."

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Types of income excluded from NII:

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

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

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

MAGI

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

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

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

Threshold Amounts

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

Married Taxpayers, Filing jointly	$ 250,000
Married Taxpayers, Filing separately	$ 125,000
All other individual taxpayers	$ 200,000

Application of the Surtax to Trusts and Estates

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

The surtax presumably will not apply to grantor trusts or to simple trusts. With a grantor trust, the grantor is treated as the owner and all items of trust income are reported on the grantor's individual tax return. Thus, the trust's items of income would be added to the grantor's items of income and any surtax would be calculated on the grantor's return. Simple trusts require all income to be distributed currently so undistributed net investment income would ordinarily be zero.

Calculating the Tax Payable

This section illustrates how the tax applies in a variety of scenarios.

Example 1: Jim, a single taxpayer has $110,000 of salary income and $60,000 of NII in 2013. The surtax applies to the lesser of $60,000 (NII) or the excess of Jim's MAGI over the threshold amount of $200,000 for a single taxpayer. Because Jim's income is less than $200,000, the excess amount is zero so no surtax is payable. Note that there can never be any surtax unless MAGI exceeds the applicable threshold amount.

Example 2: Herb and Cindy, married taxpayers filing jointly, have $1,000,000 of salary income and no NII. The surtax applies to the lesser of NII ($0) or the excess of $1,000,000 over the threshold amount of $250,000 for married taxpayers filing jointly ($750,000). Thus, no surtax is payable. There can be no surtax without NII regardless of how high MAGI is.

Example 3: Bill and Gretchen, married taxpayers filing separately, have $300,000 of salaries and $100,000 of NII. The amount subject to the surtax is the lesser of NII ($100,000) or the excess of their MAGI over the threshold amount. The threshold amount is $250,000, so the excess amount is $150,000 ($400,000 - $250,000). Thus, the amount subject to the tax is $100,000 and the surtax payable is $3,800 (.038 x $100,000).

Example 4: Carlos, a single taxpayer, has $180,000 of investment income and received a $60,000 required minimum distribution (RMD) from his traditional IRA. The RMD is included in MAGI, increasing it to $240,000. The surtax applies to the lesser of NII ($180,000) or the excess of MAGI over the $200,000 threshold amount for single taxpayers ($40,000). Thus, $40,000 is subject to the surtax and the amount payable is $1,520 (.038 x $40,000).

Example 5: Jane, a single taxpayer, has $160,000 of salary income, $30,000 of royalties, $20,000 of interest income, $40,000 of tax-exempt income and $10,000 of dividend income. This makes her MAGI $220,000 ($160,000 salary + $30,000 royalties + 20,000 interest income + $10,000 dividend income). Her NII is

$60,000 ($30,000 royalties + $20,000 interest income + $10,000 dividends). This means that the surtax applies to the lesser of investment income ($60,000) or the excess of MAGI over the applicable $200,000 threshold amount for single taxpayers, 0r $20,000. The surtax payable will be $760 (.038 x 20,000).

Example 6: Ted, a widower, has salary income of $180,000, a Roth IRA distribution of $30,000, $25,000 of income from a passive activity business and $75,000 of gain from the sale of an interest in an active business. The only item of NII is the income from the passive business. MAGI includes the salary and sale proceeds, but not the Roth IRA distribution, so MAGI is $280,000. Thus, the amount subject to the surtax is the lesser of $25,000 or $80,000 ($280,000 MAGI - $200,000 threshold amount for single taxpayers). This makes the surtax payable $950 (.038 x $25,000).

Example 7: The estate of John Doe received $20,000 of dividends in 2013 and made no distributions. Assuming an $11,200 threshold amount for trusts in 2013, the amount subject to the surtax is $8,800 ($20,000 - $11,200) and the tax payable will be $334 (.038 x $8,800).

Example 8: Assume the same facts as in Example 7 except that all the income was distributed. Under these facts, the income will be reported to the heirs and there will be no surtax exposure for the estate.

Example 9: Emma, a single taxpayer, has interest income of $200,000 and no other income in 2013. Without additional income she would not be subject to the surtax because her MAGI does not exceed her $200,000 threshold amount. However, she decides to convert her $400,000 traditional IRA to a Roth IRA. Although the $400,000 is not treated as NII, it increases her MAGI to $600,000. This makes her $200,000 of NII subject to the surtax.

Example 10: Steve (age 71) and Beth (age 64), married taxpayers filing jointly, have NII of $125,000 and salary income of $125,000 in 2013. Steve receives a $60,000 RMD from his traditional IRA. The distribution is not NII, but it increases MAGI to $310,000. As a result, $60,000 of the NII is subject to the surtax because of the RMD.

Example 11: Assume the same facts as in Example 10 except that Steve converted his traditional IRA to a Roth IRA in 2011 and received a $60,000 distribution from the Roth IRA in 2013 rather than a $60,000 RMD from a traditional IRA. Unlike an RMD, a Roth distribution does not increase MAGI. As a result, MAGI stays at $250,000 and there is no surtax even though Steve and Beth have substantial NII.

Example 12: Assume the same facts as in Example 12 except that the Roth conversion was not made until the beginning of 2013 and the amount of the conversion was $300,000. The conversion amount increases MAGI to $550,000 and makes the full $125,000 of NII subject to the surtax.

Planning for the Surtax

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

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

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

Example 2: Tom, a single taxpayer, has MAGI of $500,000, including $100,000 of NII. Recall that the threshold amount for a single taxpayer is $200,000. Thus, Tom's excess MAGI over the threshold amount is

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

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

Specific Strategies

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

Reducing Net Investment Income (NII)

The following strategies can be used to reduce NII:

1. Tax exempt bonds
2. Tax-deferred annuities
3. Life insurance
4. Rental real estate
5. Oil and gas investments
6. Choice of accounting year for trusts and estates
7. Timing of estate and trust distributions.

Tax Exempt Bonds

While interest on corporate bonds is NII, interest on tax exempt bonds is not. Thus, for affected taxpayers, the surtax can clearly be reduced by switching from corporate bonds to tax exempt bonds. But is this always a good idea? The bottom line on taxable bond investments is after-tax return. Thus, in deciding whether to substitute tax exempt bonds for taxable corporate bonds taxpayers must do some calculations as the following example illustrates.

Example: Florence, a single taxpayer in the 39.6% marginal tax bracket in 2013, owns $100,000 of corporate bonds that produce income at 6.0%. After taking the3.8 percent surtax into account, her after tax rate of return is 3.73% [6.0 - (1 - .434)]. Switching to bonds would make sense if she can earn an interest rate in excess of $3.73%. Note that the higher the effective tax rate, the lower the break-even interest rate for tax-exempt bonds would be. Similar calculations could be done to determine the break-even rates of return for other marginal tax brackets.

Tax Deferred Annuities

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

Example: Harold, a single taxpayer, has salary income of $190,000 and $40,000 of interest income in 2013. This gives him NII of $40,000 and excess MAGI of $30,000, so he will pay surtax on $30,000. When he retires in 2023, Harold's annual income will consist of $100,000 RMDs from his IRA plus the return he gets on the assets producing his current interest income. If he reinvests the interest-producing assets in an annuity that defers payments for 10 years and pays him $75,000 per year in retirement, Harold will reduce his current income to $190,000 and his NII to $0, eliminating all surtax. He will not pay surtax after retirement either, because the sum of his RMDs ($100,000) plus the $75,000 annuity payments will leave his MAGI below the threshold amount.

Life Insurance

A similar income smoothing result can be produced with

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

> ***Example:*** Jack and Jill, married filing jointly and both age 55, pay a $200,000 single premium to purchase a $1.75 million second-to-die whole life policy. After 10 years, the couple are both age 65 and entering retirement. The policy now has a cash value of $325,000. The majority of their income is now from municipal bonds and Social Security and they do not wish to draw from their IRA until they must take RMDs at age 70 ½. To tide them over, they begin by taking $40,000 of the cash value out of the policy. In the future, if they do decide to take earnings from the policy, they can do so without being subject to the 3.8% surtax provided their MAGI is below the threshold amount.

Rental Real Estate

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

Oil and Gas Investments

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

> ***Example:*** Bill and Susan, married taxpayers filing jointly, are in the 39.6% marginal income tax bracket in 2013 and have $80,000 of net investment income subject to the surtax. They invest $100,000 in a working interest in a gas well. The investment produces the following tax benefits.

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

Choice of Accounting Year for Trusts and Estates

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

> ***Example:*** George dies on February 1, 2012. In 2012, his estate has $70,000 of NII and no other income or deductions. If the estate executor selects a calendar year-end of December 31 rather than a fiscal year-end of January 31, 2013, it will save $2,234 of surtax .038 x ($70,000 - $11,200 estate threshold amount) because the surtax will not yet be in effect at the end of the estate's tax year.

Timing of Estate and Trust Distributions

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

Reducing Magi

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

Roth IRA conversions

The MAGI rules for IRAs are as follows:
(1) Distributions from traditional IRAs are included in MAGI;
(2) Income from Roth IRA conversions is included in MAGI; but
(3) Distributions from Roth IRAs are not included in MAGI.

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

> ***Example:*** John is a single taxpayer with $190,000 of NII and RMDs of $100,000 per year from his traditional IRA. If he leaves the assets in the traditional IRA, his NII for 2013 and subsequent years will be $190,000 and his MAGI will be $290,000. Thus, he will pay surtax on $90,000 of income each year. John can avoid the surtax by doing a Roth IRA conversion before 2013. This will convert the $100,000 RMD payments that are included in MAGI to $100,000 Roth distributions that are not included in MAGI, reducing his MAGI to $190,000 and eliminating the surtax. This would save John $3,800 each year beginning in 2013. Note that there is also no surtax on the conversion because the tax does not yet apply. The conversion will also reduce NII if the taxpayer pays the tax on conversion using assets that produced net investment income.

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

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

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

> ***Example:*** Roger, a taxpayer in the 35% marginal income tax bracket in 2010 has $100,000 in a traditional IRA and $35,000 of liquid assets in a side fund. Assume that the assets in the IRA will triple in value over the next 20 years, but the liquid assets will only double in value because the investment returns are subject to tax. Assume further that Roger is in the same 35% marginal tax bracket at the end of 20 years. If Roger declines to convert, he will have $300,000 in his traditional IRA and $70,000 of liquid assets at the end of the 20-year time frame. The assets in the traditional IRA have an after-tax value of $195,000 (.65 x $300,000), effectively leaving him with $265,000 ($70,000 + $195,000). By contrast, if Roger did a Roth conversion, the $35,000 side fund would be used to pay the conversion tax so there would be no liquid assets after 20 years and $300,000 in the IRA and the IRA would again have $300,000 of assets. Since this amount could now be distributed tax-free, however, the total value would now be $300,000 instead of $265,000, The additional $35,000 represents the tax payable on the side fund. In effect, $35,000 of taxable investment assets were allowed to grow tax-free.

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

Charitable Remainder Trusts

These trusts pay a lead annuity or unitrust interest to the grantor or another non-charitable beneficiary, with the remainder interest passing to charity at the end of the trust term. An annuity interest is payment of a fixed percentage of the initial value of the trust assets each year. This means that the payments are the same each year. By contrast, a unitrust interest is payment of a fixed percentage of the trust assets re-determined each year to reflect changes in the value of the trust assets so that payments

vary every year. Charitable remainder trusts (CRTs) that pay an annuity to the lead beneficiary are called charitable remainder annuity trusts (CRATs) and charitable remainder trusts that pay a unitrust amount are referred to as charitable remainder unitrusts (CRUTs).

Example (CRAT): Anne transfers $1,000,000 to a trust that pays her 10 percent of the initial trust value at the end of each year for 15 years with the remainder passing to charity. Anne receives a $100,000 payment each year regardless of the trust's investment performance.

Example (CRUT): Assume the same facts as in the previous example except that the amount of the annual payout is 10 percent of the value of the trust assets, redetermined each year based on the value of the assets at the beginning of the year. Assume further that the trust assets perform well so that there is $1,100,000 in the trust at the beginning of Year 2, $1,200,000 at the beginning of Year 3 and $1,300,000 at the beginning of Year 4. The unitrust payments will be $100,000 in Year 1, $110,000 in Year 2, $120,000 in Year 3 and $130,000 in Year 4.

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

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Charitable Lead Trusts

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

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

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

Installment Sales

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

Above-the-Line Deductions

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

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