Facing the 3.8 Percent Medicare Tax on Investment Income

By Patricia J. Reuter, CPA, CGMA

On June 28, the U.S. Supreme Court released a landmark decision on the constitutionality of the health coverage mandate of President Obama's *Patient Protection and Affordable Care Act of 2010*. In a 5-4 decision, the Court upheld the provision citing that the payments by individuals for failure to maintain "minimal essential coverage" are permissible under Article 1 of the Constitution, which allows Congress the power to "lay and collect taxes." While the pundits continue to argue the merits of the decision and whether the mandate is a tax or a penalty, it is our role as tax advisers to determine the tax impact facing our clients and offer strategies to lessen the burden.

In addition to the overhaul of the U.S. health care system, the legislation added a number of new taxes. One of the most significant new taxes is the 3.8 percent Medicare surtax, which becomes effective Jan. 1, 2013. The surtax was put in place to help finance healthcare reform and impacts individuals, trusts and estates with income exceeding specific thresholds. Without further action from Congress, this surtax will come at the same time as the sunset of the Bush tax cuts. Instead of the top tax rate rising from 35 percent to 39.6 percent, with the imposition of the surtax, the top tax rate will be 43.4 percent.

Threshold

For an individual, the 3.8 percent tax is imposed on the lesser of (i) "net investment income" for the tax year, **or** (ii) the amount by which the "modified adjusted gross income" exceeds the threshold amount based on their filing status as follows:

FILING STATUS	THRESHOLD
Married filing jointly, or qualifying widow(er)	$250,000
Single, head of household	$200,000
Married filing separately	$125,000

"Modified adjusted gross income" (MAGI) is adjusted gross income increased by the net amount of foreign-sourced income that was exempt for regular tax purposes.

For trusts and estates, the 3.8 percent tax is imposed on the lesser of (i) undistributed net investment income for the year; **or** (ii) the excess of adjusted gross income over the dollar amount at which the highest tax bracket begins ($11,650 in 2012; approximately $12,000 in 2013 indexed for inflation).

What is Investment Income?

Net investment income includes the following items, reduced by any deductions allocable to the respective income:

- Interest, dividends, royalties, annuities;
- Income derived from rents and other passive activities;
- Net capital gains derived from the disposition of property (other than property held in an active trade or business; and
- Trading of financial instruments and commodities.

What is *not* Investment Income?

Generally, income or gain excluded for regular tax purposes would also be excluded from the 3.8 percent tax, such as:

- Income from tax exempt bonds;
- Qualified pension, profit-sharing or stock bonus plan distributions;
- Distributions from IRAs and Roth IRAs;
- Active trade or business income;
- Income subject to self-employment tax;
- Gain on the sale of an active interest in a partnership or S corporation; and
- Gain on the sale of a principal residence that is excluded from income under IRC §121 (up to $250,000; $500,000 for a married couple filing a joint return).

Minimizing the Medicare Surtax

Implementation of tax strategies should be considered to minimize the impact of the 3.8 percent surtax. A few planning techniques to consider include:

- Defer income to reduce your MAGI each year below the threshold.
- Consider investing in tax-exempt municipal bonds. Compare the after-tax yields of taxable vs. tax exempt bonds to determine if this is advantageous, factoring in the 3.8 percent surtax, as well as potential state tax and AMT exposure.
- Non-dividend or low dividend paying stocks with capital appreciation may be more beneficial, especially if the dividends are taxed at ordinary income rates in 2013.
- Harvesting losses might be advantageous assuming long-term capital gains rates of 20 percent plus the 3.8 percent surtax.
- Increase participation in passive activities to make income non-passive.

- Consider Roth conversion before 2013. Although this income is not subject to the 3.8 percent surtax, it could potentially increase the MAGI over the threshold. Further distributions from the Roth IRA would not be taxable.
- Above the line deductions such as contributions to self-employed retirement accounts, Health Savings Accounts, and traditional IRA accounts could reduce the MAGI and surtax exposure.

Conclusion

At this point, there are more questions than answers. The IRS is expected to issue guidance on the surtax in the near future that will address the uncertainties. In the infamous words of former Speaker of the House Nancy Pelosi, Congress has to "pass the bill, so you can find out what's in it." We are about to discover just what that means. Clearly, it is time for comprehensive tax reform. Hopefully, Congress engages the CPA community to help outline and define what those reforms should be.

Pat Reuter, CPA, CGMA, is a senior vice president and tax team leader for Personal Tax Solutions at U.S. Trust, Bank of America Private Wealth Management in St. Louis. She is the treasurer of the MSCPA, and chair of the Investments Committee for 2012-2013. In addition, she serves on the MSCPA Taxation Committee. Pat can be contacted at patricia.j.reuter@ustrust.com.