PLANNING FOR HIGHER MEDICARE TAXES

Consider strategies to reposition assets for the higher Medicare tax landscape

KEY TAKEAWAYS

Starting in 2013, high-income taxpayers face an additional 0.9% Medicare tax on some wages and 3.8% on net investment income or a portion of their income.

▼

This paper includes numerous tax planning tips on how to minimize the additional Medicare taxes, including accelerating capital gains and reallocating taxable investment portfolios.

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INTRODUCTION

Beginning in 2013, high-income taxpayers are subject to two additional Medicare taxes that could have a substantial impact on their overall tax bill. There may be actionable strategies you can consider to offset the effect of rising taxes.

This is an important time to consult with your financial and tax advisors to help position your finances to keep more of your money and develop a plan to react to the pending changes. The following is an overview of the additional Medicare taxes and tax-planning strategies you may want to consider.

DEFINING HIGH-INCOME TAXPAYERS

New legislation defines those affected by the additional Medicare taxes as high-income taxpayers. These are individuals with modified adjusted gross income (MAGI) in excess of $200,000, or for married couples filing jointly, MAGI over $250,000. MAGI is adjusted gross income – line 37 on your 2012 Form 1040 – increased by any net foreign sourced income that was excluded from gross income.

DEFINING NET INVESTMENT INCOME

Net investment income (NII) consists of interest, dividends, annuities, royalties, rental income, passive activity income and capital gains from the sale of property less allowable expense deductions like advisory fees and commissions.

Note that NII does not include tax-exempt bond income, IRA or qualified retirement plan distributions, self-employment income, income from an active trade or business, or gain on the sale of an active interest in a partnership or S corporation.

TWO NEW MEDICARE TAXES

1 MEDICARE INCOME TAX

The first new Medicare tax that impacts high-income taxpayers, as defined previously, is an additional tax imposed on wages and self-employment income. As legislation stands, effective January 1, 2013, if you exceed the MAGI thresholds, the percent of Medicare tax you pay on your wages in excess of the threshold will increase from the current 1.45% to 2.35%, a 0.9% increase.

One facet to be aware of is that while an employer must withhold on the higher rate if your wages are in excess of $200,000, employers won't be responsible for determining whether a worker's combined income with his or her spouse makes them subject to the tax. The additional tax not withheld by your employer – because individually you didn't earn wages in excess of $200,000, but together you exceeded $250,000 – will have to be paid when you file your tax return. On the other hand, if you were taxed on individual wages in excess of $200,000, but the income on your joint tax return is less than $250,000, you will get a tax credit for the amount overpaid.

2 MEDICARE SURTAX

Pursuant to the Health Care and Education Reconciliation Act of 2010, there is also a Medicare surtax of 3.8% applied to net investment income for high-income taxpayers. The tax is determined by taking 3.8% of the *lesser* of your net investment income or the excess of MAGI over the thresholds described for high-income taxpayers. If either of these two numbers is zero, the tax is also zero.

TIP

PLANNING TIP:

If you reach the threshold for the additional 0.9% Medicare income tax on a joint basis, but not on an individual basis, try to work with your employer to adjust the percent they withhold from your wages. Alternatively, work with your financial advisor and position your portfolio to prepare for the higher tax bill in April.

HOW THE MEDICARE INCOME TAX WORKS

EXAMPLE NO. 1:
A single individual earns $250,000 in wages.

Old Tax = $3,625 (1.45% x $250,000)
New Tax = $4,075 [(1.45% x $200,000) + (2.35% x $50,000)]
Tax Increase = $450

$450
tax increase

EXAMPLE NO. 2:
A married couple filing jointly; one spouse earns $160,000 and the other earns $240,000. (Joint wages of $400,000 reach high-income threshold.)

Employer withholding for each:
$2,320 ($160,000 x 1.45%) and $3,480 ($240,000 x 1.45%)

Combined Medicare tax withholding: $5,800

Additional amount not withheld and due with tax return:
$1,350 [($400,000 - $250,000) x 0.9%]

$1,350
due with tax return

HOW THE MEDICARE SURTAX WORKS

EXAMPLE NO. 1:
A married couple filing jointly has $150,000 NII and $275,000 MAGI.

Tax = 3.8% x (Lesser of NII or MAGI in excess of the $250,000 threshold)
= 3.8% x (Lesser of $150,000 or $25,000)
= 3.8% x $25,000 = $950

$950
surtax in this example

EXAMPLE NO. 2:
A single individual has $50,000 NII and $100,000 MAGI.

Tax = 3.8% x (Lesser of NII or MAGI in excess of the $200,000 threshold)
= 3.8% x (Lesser of $50,000 or $0)
= 3.8% x $0 = $0

$0
surtax in this example

EXAMPLE NO. 3:
A married couple filing jointly has just sold its principal residence for a net gain of $700,000. $500,000 of that gain is sheltered by the home sale exclusion. This leaves them with $200,000 NII. They earn a combined salary of $175,000 a year. They therefore have $375,000 MAGI ($175,000 salary & $200,000 net gain).

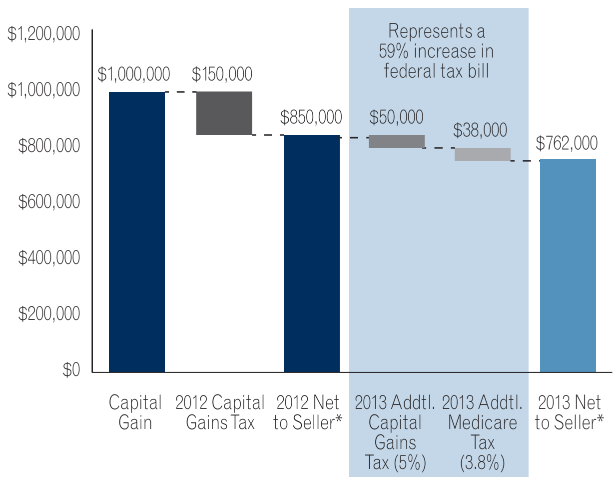
Tax = 3.8% x (Lesser of NII or MAGI in excess of the $250,000 threshold)
= 3.8% x (Lesser of $200,000 or $125,000)
= 3.8% x $125,000 = $4,750

$4,750
surtax in this example

THE BIG PICTURE

Let's take a look at the capital gains tax to help put the impact of the 3.8% surtax into perspective. Based on current tax legislation the maximum long-term capital gains tax is 20%. When you add in the 3.8% surtax, you'll pay a top tax rate of 23.8% on capital gains if you meet the thresholds defined earlier. Given the increased rates it is important to consider the impact of higher tax rates.

2013 LONG-TERM CAPITAL GAINS RATE INCREASES



*Net does not incorporate state and local taxes due as these vary by state. Source: Transact AOCP; 2012. For illustrative purposes only. Actual figures may vary depending on your personal tax situation.

STRATEGIES TO HELP MINIMIZE NEW MEDICARE TAXES:

- Consider replacing your small business 401(k) with a Defined Benefit plan, which would allow for maximum contributions and greater tax-deferred accumulations.
- Replace corporate bonds with tax-free bonds.** Interest on tax-free bonds, such as municipals, is not counted in NII or MAGI. Interest on corporate bonds increases both NII and MAGI.
- Reallocate taxable investment portfolios to increase growth investments and reduce dividend income. This will help reduce NII and MAGI.
- Contribute highly appreciated assets to a charitable remainder annuity trust or unitrust (CRAT or CRUT). Proceeds from assets sold inside a CRT may be reinvested without exposure to capital gains tax or the 3.8% Medicare tax. CRT distributions to the grantor will be included in MAGI and so may trigger the 3.8% Medicare tax.
- Carefully consider the timing of future Roth IRA conversions and required minimum distributions. Traditional IRA required minimum distributions (RMDs) drive up MAGI, which may cause NII to be exposed to the 3.8% Medicare tax. Roth IRA distributions are not included in MAGI. Remember that any amount converted, to the extent taxable, is ordinary income in the conversion year.
- Purchase tax-deferred annuities and whole life insurance to shift away from assets producing current NII and MAGI and defer income into future years where it may be subject to lower income tax rates and perhaps not exposed to the 3.8% Medicare tax.

**Income is not subject to federal income taxation; however, it may be subject to state and local taxes and, for certain investors, may be subject to the federal alternative minimum tax.

CONCLUSION

While planning for higher taxes is important, it is equally important that you do not make changes to your investment portfolio or financial plan based on tax considerations alone. There are a number of factors that may influence your total tax bill and your financial objectives. Your Raymond James financial advisor can help you review how today's tax environment may impact your personal situation. He or she also can work with your accountant or tax professional to coordinate appropriate tax strategies.

Remember, what is most critical is establishing your personal goals for both the short and long term. Tax strategies can be used to help you achieve these goals and should be utilized within the context of your overall financial picture.

WORK WITH YOUR FINANCIAL ADVISOR

Work with your financial advisor and tax professional to identify and implement tax-planning strategies that are advantageous for your situation.

▶ Discuss potential strategies depending on how recent tax legislation may impact your personal circumstances.

▶ Take action in a timely manner to reposition assets in line with the strategies decided upon with your financial advisor.

Please note, changes in tax laws or regulations may occur at any time and could substantially impact your situation. Raymond James financial advisors do not render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.

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