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Lane Gorman Trubitt, PLLC  
Accountants & Advisors

Your Accounting for a New Economy

# 3.8% Medicare Tax on Unearned Income: Are You Prepared?

As part of the Health Care and Education Reconciliation Act of 2010, beginning in 2013 some individuals will be subject to a new 3.8% Medicare contribution tax on unearned income. The new tax, implemented as a means to help pay for President Obama's health care reform, targets wealthier taxpayers and is not deductible when computing income tax. While still more than a year away, taxpayers subject to this tax need to begin making preparations now before the tax takes effect.

Taxpayers subject to the new tax include:

- Single taxpayer with a modified adjusted gross income (MAGI) in excess of \$200,000
- Married taxpayers with a MAGI in excess of \$250,000 filing a joint return
- Married taxpayers with a MAGI in excess of \$125,000 if filing separately

The tax is equal to 3.8% of the lesser of net investment income or the amount by which MAGI exceeds the amounts listed above.

For most people, MAGI will be their adjusted gross income. One notable exception is U.S. citizens living abroad with foreign earned income.

Under the new law, modified adjusted gross income, or MAGI, is defined as Adjusted Gross Income increased by the excess of –

1. The amount excluded from gross income by qualified electing individuals for foreign earned income under section 911(a)(1), currently 80,000 over
2. The amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).

The net investment income used to calculate the amount owed for the tax includes:

- Interest
- Dividends
- Annuities
- Royalties
- Rents, unless the rents are derived in the ordinary course of a trade or business
- Income from passive activities, such as trading in financial instruments or commodities
- Most capital gain income (Net gain attributable to the disposition of property other than property held in an active trade or business)
- Taxable gain on the sale of a personal residence in excess of the exclusion of up to \$500,000 for qualifying residences under IRC Section 121
- Other such income that is derived in the ordinary course of a trade or business, less allocable deductions

Estates and trusts are not immune. They are subject to the tax on the lesser of:

- Undistributed net investment income, or the
- Excess of adjusted gross income in excess of the highest tax bracket (amounts over 11,350 as of 2011)

However, net investment income does NOT include distributions from qualified plans such as:

- Qualified pension
- Profit sharing
- Stock bonus plans
- Qualified annuity plans
- Annuities purchased by Sec. 501(c)(3) organizations or public schools
- Individual retirement accounts
- Roth individual retirement accounts
- Eligible deferred compensation plans
- Tax-exempt interest
- Trust that is exempt from the tax under section 501
- Charitable remainder trust except from tax

## **Planning Ahead**

In order to be ready when the tax takes effect, investors should begin planning now and be prepared to take more specific action in October, November and December of 2012.

### What investors should be doing later in 2012:

- Analyze your investment portfolio and harvest any year-end gains. Since the wash sale rules do not apply to gains, selling a security at year end and repurchasing it may make sense if the investment is still a good portfolio choice.
- Investors may want to pass on capturing dividends and look at investments providing long-term capital gain. While usually just a deferral tactic, this could become especially effective if the investor is looking to change jobs soon or retire, at which point it would become a permanent tax savings if the investor's future income falls below the threshold.
- Start looking at tax-exempt bonds and remember to factor in the new Medicare rate when comparing them to taxable interest investments.
- Look at converting nonqualified investments to a qualified plan that would be exempt from the tax.
- Investigate your insurance options – The inside buildup of life insurance cash surrender value is not subject to the new tax, nor are life insurance proceeds that are excluded from income tax.
- Hedge funds are considered active trades or businesses and not subject to this tax. Because of this, some investors may argue that their investment is an active trade or business and not subject to this tax, but Congress anticipated this and Section 1411 (c)(2) specifies that “a trade and business of trading in financial instruments or commodities” is subject to this tax.
- A working interest in an oil and gas property an investor holds through an entity that does not limit the taxpayer's liability, or one held directly, is not considered a passive activity.
- Oil and gas production payments, royalties, or other income arrangements are subject to the tax if the investment is not a working interest.

### What business owners need to know:

- Only businesses or trades that are a passive activity are subject to this tax. Active business ownership such as a sole proprietorship, limited liability company (LLC), partnership, or S Corporation are exempt.
- Upon the disposition of an interest in a partnership or an S Corporation, only the gain attributed to the disposition of non-active assets would be subject to Medicare tax.
- Owners of a pass-through active trade or business may find that the portion of the flow-through income derived from gain or loss attributable to an investment of working capital will be subject to the Medicare tax.
- Interest, dividend and royalty income earned in the normal course of trade or business is not subject to this tax, however idle cash-producing investment income is.
- Owners of an interest in a business that has both active and passive activities will find that the portion of income subject to this tax will be determined by the allocation of the fair market values of all assets immediately before the disposition of the interest.

## **Conclusion**

Taxpayers earning above the threshold with investments that produce income will be subject to the tax. However, the new tax doesn't take effect until tax years starting after December 31, 2012 giving taxpayers a lengthy window to develop strategies for minimizing the tax impact.

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