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Now That the Election Is Over, How Do You Plan for 2013's New Tax on Investment Income?

BY KEVIN GHASSOMIAN

President Obama's re-election and the Democrats' retained control of the Senate mean that a repeal of the Patient Protection and Affordable Care Act before its tax provisions go into effect in early 2013 is highly unlikely.[1]

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As a result, investors now fear a potential top tax rate as high as 43.4 percent due to the combined impact of expiring Bush tax cuts and a new "Medicare surtax"[2] on investments. Anticipating the rate increase, tax advisers have been actively engaged in planning to avoid or minimize the new surtax.

This article will assist those taxpayers who have been waiting to plan by showing how the surtax is applied and identifying techniques that can be used to address it.

Applying the New Tax on Investment Income

The new investment surtax applies to individuals, estates, and trusts.[3] Although it has been characterized generally as a 3.8 percent income tax increase, the 3.8 percent is actually a new rate imposed on the lesser of:

- net investment income, or
- the excess of modified adjusted gross income over certain thresholds.[4]

To plan for the tax, one must first understand what its key terms mean and how they impact various taxpayers.

Net Investment Income

Net investment income is essentially any income derived from capital reduced by expenses associated with that capital.[5] Thus, net investment income includes interest, dividends, royalties, rents, capital gains from the sale of investments,[6] passive income from businesses,[7]

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[1] Fox, Emily Jane. "Obama's re-election secures health care reform,"*CNNMoney*, Nov. 7, 2012, http://money.cnn.com/2012/11/07/pf/health-care-reform-obama/index.html.

[2] The new investment tax is sometimes referred to as the "Medicare surtax" because it is called the "Unearned Income Medicare Contribution" in the law enacting it. Despite the name, however, there appears to be no reason why revenue generated by the tax must be used for Medicare.

[3] Section 1411 of the Internal Revenue Code. Except as otherwise indicated, references are to the Internal Revenue Code (26 U.S.C.) and the Treasury regulations issued thereunder (26 CFR).

[4] I.R.C. Section 1411(a).

[5] I.R.C. Section 1411(c).

[6] Gain on the sale of a principal residence is net investment income only to the extent it exceeds $250,000 for a single taxpayers and $500,000 for joint filers. I.R.C. Section 121. For rental property or a second home, the entire amount of the net gain on a sale is included in net investment income. See Congressional Research Service Report for Congress—The 3.8% Medicare Contribution Tax on Unearned Income, Including Real Estate Transactions, 2010 ARD 183-104, 111th Congress.

and the taxable portion of nonqualified annuity payments.[8]

Net investment income does not include distributions from a retirement plan such as a traditional individual retirement arrangement, Roth IRA, or 401(k) and payouts from traditional defined benefit pension plans or annuities that are part of retirement plans.[9] Also exempt are life insurance proceeds, veterans' benefits, Social Security benefits,[10] interest from municipal bonds,[11] and income from businesses in which the taxpayer actively participates.[12]

Modified Adjusted Gross Income

The definition of modified adjusted gross income begins with adjusted gross income (AGI), which includes a taxpayer's wages, taxable interest, capital gains, unemployment compensation, tips, dividends, taxable portion of Social Security, retirement plan distributions, and any income derived from partnerships and other small businesses.[13]

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AGI is ''modified,'' under the new investment surtax, to include foreign earned income and foreign housing costs.[14] Thus, modified AGI can be higher than AGI because it is calculated by adding back otherwise deductible items.

Threshold Amounts

The new investment surtax applies to individual taxpayers on the lesser of their net investment income or the amount of modified AGI above certain thresholds. The threshold amounts are $250,000 for married taxpayers filing jointly or a surviving spouse; $125,000 for married taxpayers filing separately; and $200,000 for single and head of household taxpayers.[15] It is important to note that the aforementioned thresholds for individual taxpayers are not indexed for inflation. Thus, as income adjusts for inflation, a growing number of taxpayers will be subject to the surtax over time.

For an estate or trust, the surtax applies to the lesser of the undistributed net investment income for the year or the amount of AGI that exceeds the dollar amount at which the highest tax rate bracket begins for estates and trusts, which is $11,650 for 2012.[16] The highest bracket for estates and trusts is indexed for inflation but with such low thresholds, estimated at a mere $12,000 in 2013, the surtax is more readily applicable to estates and trusts than to individuals.

Impact Upon Individuals, Estates, and Trusts

Individual Scenarios. If an individual taxpayer's modified AGI is equal to or less than the applicable threshold, then the new investment surtax will not apply. But when modified AGI is greater than the threshold amounts, the surtax will apply to the lesser of net investment income or the excess of modified AGI over the applicable threshold, as follows:

- **Individual Scenario 1.** James and Erin, married filing jointly, receive $500,000 of wages but have no other income. The surtax would not apply because they have no net investment income.

- **Individual Scenario 2.** Brady and Tina, married filing jointly, have $500,000 of salary income and $50,000 of net investment income. The surtax would apply only to the $50,000 of net investment income because the $50,000 of net investment income is less than their excess of modified AGI over the applicable threshold (i.e., $550,000 - $250,000 = $300,000 of excess modified AGI).

- **Individual Scenario 3.** Tyler, a single filer, has $275,000 of net investment income and no other income. The Medicare surtax would apply to $75,000 of income because his modified AGI was $75,000 over the applicable $200,000 threshold amount for single filers.

- **Individual Scenario 4.** Donnie and Kristen, married filing jointly, have $225,000 of salary income and $125,000 of net investment income. Their modified AGI is $350,000 and the applicable threshold is $250,000. Thus, the surtax would apply to $100,000 of income because the difference between their threshold and modified AGI is less than the amount of their net investment income of $125,000.

- **Individual Scenario 5.** Nick and Marlin, both of whom are age 69, have pension and qualified plan income of $550,000, $35,000 of tax-exempt income, and no taxable investment income. The surtax does not apply because they have no net investment income.

Estate and Trust Scenarios. For estates and trusts, the surtax is imposed on the lesser of undistributed net investment income or the excess of the estate or trust's AGI[17] over the dollar amount at which the highest tax bracket begins.[18] Because the highest tax bracket for estates and trusts begins at a low level of income, $11,650 for 2012, the investment surtax is particularly bothersome:

- **Trust Scenario 1.** The Boone Trust may pay income and principal as needed to Paula, who is single. In

[7] I.R.C. Section 469 defines business activities as passive unless the taxpayer ''materially participates'' in the activity. Material participation requires the taxpayer's involvement in the operations of the business to be regular, continuous, and substantial (Section 469(h)(1)). The current regulations treat a taxpayer as materially participating in an activity if he or she meets one of seven tests during the tax year. The clearest of these tests is the taxpayer's participation in the trade or business for more than 500 hours in the tax year (Temp. Regs. Section 1.469-5T(a)).

[8] I.R.C. Section 1411(c)(1)(A).

[9] I.R.C. Section 1411(c)(5).

[10] I.R.C. Section 1411(c)(1), (6).

[11] I.R.C. Section 1411(c)(1)(B).

[12] I.R.C. Section 469(h)(1).

[13] I.R.C. Section 62.

[14] Both of which would be otherwise excluded from AGI by Section 911 (a)(1).

[15] I.R.C. Section 1411(b).

[16] Rev. Proc. 2011-52, 2011-45 I.R.B. 3.

[17] I.R.C. Section 67(e).

[18] I.R.C. Section 1411(a)(2)(ii).

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2013, the trust has dividend and interest income of $150,000, and net capital gains of $300,000. The trust makes no distributions to Paula. The Boone Trust has modified AGI of $450,000. Assuming the applicable threshold is still $11,650, then $438,350 of the net investment income would be subject to the surtax and the trust would pay $16,657.

■ **Trust Scenario 2.** The facts remain the same, except that the $150,000 of dividend and interest income is distributed to Paula, who has no other income. Since the threshold for single taxpayers is $200,000, Paula will not be subject to the surtax on her net investment income of $150,000. The Boone Trust would be taxable on the capital gains of $300,000. Assuming the trust threshold amount is $11,650, $288,350 of the capital gains would be subject to the surtax. The Boone Trust would therefore only pay $10,957, a savings of $5,699 compared to prior trust scenario.

Expiration of the Bush Tax Cuts

The Economic Growth and Tax Relief Reconciliation Act of 2001, known popularly as the ''Bush tax cuts,'' ushered in a comprehensive suite of tax reductions that lasted for nearly a decade. The reduced Bush rates were legislatively set to expire at the end of 2010; however, the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the expiration date by two years.

Reversion to the higher pre-Bush rates coincides with the imposition of the new investment surtax, making this one of the more significant tax hikes in our nation's history.

The extension expires at the end of 2012 and without additional tax legislation, rates will revert to higher pre-Bush levels at the beginning of 2013. Reversion to these higher rates coincides with the imposition of the new investment surtax, also slated to begin in 2013, making this one of the more significant tax hikes in our nation's history.

Throughout the 2012 campaign, President Obama called for another extension of the expiring Bush tax cuts, but—over Republicans' objections—only for households with taxable income of less than $250,000 a year. Thus, without legislative intervention prior to year-end, investors will face the following new tax rates.[19]

[19] The pending increases do not include the restoration of the Pease provision that was phased out by the Economic Growth and Tax Relief Reconciliation Act of 2001. Named after Rep. Donald Pease (D-Ohio), this law rescinds up to 80 percent of the value of a taxpayer's itemized deductions for those in the top tax bracket. It applies to most of the itemized deductions a taxpayer claims, including deductions for mortgage interest, state and local taxes, and charitable contributions. Thus, for taxpayers in the top 39.6 percent tax bracket, this treatment effectively adds another 1.2 percent, resulting in a combined marginal tax rate of 40.8 percent.

Ordinary Investment Income

Ordinary income items in an investment portfolio, such as interest, rents, and short-term gains are currently subject to a top tax rate of 35 percent. This rate reverts to 39.6 percent at the end of the year.

For taxpayers subject to the new investment tax, a further increase of 3.8 percent will apply, resulting in a new top rate of 43.4 percent to be borne by taxable investment portfolios in 2013.

Qualified Dividends

Though the pending tax rate increase on ordinary portfolio income is substantial, it pales in comparison to the scheduled change in tax treatment of qualified dividends. The current rate of 15 percent will rise to 39.6 percent to align with the tax rate on interest and short-term gains.

When combined with the new investment tax, the total rate on dividends for higher-income taxpayers will be 43.4 percent. This means that taxes on dividend income will nearly triple in 2013.

Long-Term Capital Gains

The tax rate on long-term capital gains will remain relatively modest compared to the aforementioned rates on ordinary portfolio income and dividends. Before taking too much comfort in this news, investors will still need to be prepared for an increase in the long-term capital gains tax rate.

The current rate of 15 percent will rise to 20 percent with the expiration of the Bush tax cuts, and, with the addition of the new investment tax, the long-term capital gains rate will be 23.8 percent in 2013. This represents an increase of more than 58 percent over the current rate.

Tax Planning Considerations

As discussed above, the investment surtax applies to taxpayers, including estates and trusts, with both net investment income and modified AGI above certain thresholds. Thus, taxpayers can minimize the impact of the surtax by reducing either investment income or modified AGI, or ideally both.

There are several ways to accomplish this.[20]

Investment Planning

Municipal Bonds. Tax-exempt municipal bonds can minimize taxable income while reducing exposure to the new investment surtax because their income is not included in net investment income or modified AGI. Investors may wish to consider rebalancing their portfolios and reallocating assets to municipal bonds prior to year-end to take advantage of the current long-term capital gain rate.

Growth Stocks. Non-dividend paying growth stocks do not increase investment income or modified AGI until they are sold. Thus, investors seeking to lessen expo-

[20] Investors must always be mindful that any strategy focused purely on reducing tax exposure should be embarked upon only after considering the long-term consequences on their overall financial plans. Thus, these considerations should only be employed after thorough consultation with appropriate tax and investment professionals having detailed knowledge of the investor's specific circumstances.

sure to the investment surtax may favor stocks with little or no dividends to reduce taxable income and defer capital gains tax until it is more advantageous from a tax standpoint.

Annuities. Annuities allow for the tax-deferred accumulation of income while providing the annuity holder with flexibility to receive income in a lump sum or periodic payments, either immediately or at some future date. The annuity's earnings grow free of federal, state, and local income taxes until payments are received.[21]

With this added control over future income streams, annuities can be used to manipulate net investment income and modified AGI, keeping both below surtax thresholds and thereby minimizing or eliminating the investment surtax in any given year.

Life Insurance. Cash buildup within a whole life insurance policy offers tax-deferred growth, free from current income tax and the investment surtax.[22] Thus, taxpayers subject to the investment surtax can reallocate investment dollars from assets that produce net investment income or modified AGI into a whole life insurance policy that produces neither.

Retirement Planning

Retirement Accounts. Though distributions from qualified retirement accounts are excluded from the definition of net investment income,[23] if made from a traditional IRA or 401(k), such distributions are included in AGI[24] and could push recipients above modified AGI thresholds and into surtax exposure. Roth IRAs and Roth 401(k)s avoid this problem as their distributions are not included in net investment income[25] or modified AGI.[26] As such, higher-income taxpayers are generally incentivized to contribute to Roth type plans, rather than traditional retirement plans.

Of course, this is not always the case. Taxpayers in any given year may prefer to contribute to a traditional plan because contributions to traditional plans reduce modified AGI whereas contributions to Roth plans do not.[27] Thus, taxpayers at or above surtax thresholds can escape the surtax by making contributions to traditional plans that lower modified AGI and avoid the surtax trigger.

Roth Conversions. Roth IRAs have many advantages when compared to traditional IRAs. Roth IRAs do not require minimum distributions, offer tax-free growth, and qualified distributions are tax-free.[28] Moreover, Roth IRA distributions, as noted above, are not considered net investment income and will not increase modified AGI or otherwise trigger exposure to the investment surtax. For these reasons, high-income taxpayers should consider a conversion of traditional IRAs to a Roth IRA.

Note, however, that a Roth conversion itself would trigger a spike in income, which would raise modified AGI and increase exposure to the investment surtax in the year of the conversion. Thus, converting to a Roth this year would avoid that result, since the surtax does not apply until 2013.

Capital Gain Planning

Gain Harvesting. Taxpayers who have held appreciated capital assets for more than a year should consider selling the assets before year-end to trigger the long-term capital gains treatment at current rates rather than next year's anticipated higher rates.[29]

For this same reason, it is also a good time for investors to consider diversifying concentrated stock positions in their equity portfolios, as delaying the sale of stock until next year would subject any gain on the sale to the rate increase.

Installment Sales. By using the installment method of accounting to report gain on the sale of property, taxpayers can minimize exposure to the investment surtax because it helps them to avoid a large increase in both net investment income and modified AGI in the year of the sale. This is because gain in a qualified installment sale is recognized proportionately to the payments received over the term of the installment note.[30] Thus, the longer the term, the longer the tax can be deferred.

Taxpayers selling property on an installment basis in 2012 should consider electing out of the installment method and recognizing the entire amount of the gain before the investment surtax goes into effect.

Note, however, that taxpayers selling property on an installment basis in 2012 should consider electing out of the installment method and recognizing the entire amount of the gain before the investment surtax goes into effect in 2013.

Like-Kind Exchanges. A like-kind exchange is another deferral technique that enables taxpayers to avoid recognition of gains by exchanging business or investment property for property of the same nature or character.[31]

[21] I.R.C. Section 72(e).
[22] I.R.C. Section 72(b)(1).
[23] I.R.C. Section 1411(c)(5).
[24] I.R.C. Section 62.
[25] I.R.C. Section 1411(c)(5).
[26] I.R.C. Section 1411(d).
[27] I.R.C. Section 408A(c)(1).
[28] I.R.C. Section 408A(d)(1).

[29] If the sale involves a residence at a gain above the I.R.C. Section 121 exemption amount of $250,000 for single filers or $500,000 for married couples filing jointly, a taxpayer should probably do so in 2012 to lock in the current long-term capital gains rate.
[30] I.R.C. Section 453.
[31] Under I.R.C. Section 121, many types of property can qualify as "like-kind" to one another; but, as a general rule, "like-kind" property must (1) be held for investment purposes or for productive use in a trade or business and (2) qualify as a real property interest under state law. Care must be taken if the exchange involves a vacation home, as rules limit the amount of personal use by the owner for the vacation property to qualify for nonrecognition treatment. There are also timing rules that must be followed. For instance, if the sale and purchase of the like-kind property does not occur simultaneously, a "qualified intermediary" can hold the funds from the sale and then use the funds to buy the replacement property within

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By deferring gain to a year when modified AGI is otherwise low, exposure to the investment surtax can be minimized. Unfortunately, the like-kind exchange is limited in its applicability, as many of the most common types of investment assets, including stocks, bonds, notes, and other securities, are excluded from nonrecognition treatment.[32]

Estate and Trust Planning

Inter Vivos Gifting. Taxpayers can effectively reduce or rid themselves of the surtax by gifting assets that trigger the tax.[33] This is a common estate planning technique and perhaps the simplest means of addressing the investment surtax. If gifted property appreciated while in the hands of the donor, the donee takes the asset at the donor's basis, resulting in the deferral of gains until the donee enters into a taxable transaction involving the gifted property.

Gifting strategies take on increased importance in 2012, as the lifetime gift tax exemption is currently at an all-time high of $5.12 million,[34] an amount set to drop dramatically upon the expiration of the Bush tax cuts. As a result, 2012 provides a window of opportunity for making substantial gifts shielded by the federal gift tax exemption.[35]

Trust Distributions. Threshold amounts for the investment surtax are significantly lower for trusts and estates, $11,650 for 2012, than they are for individuals, $200,000 for single filers and $250,000 for joint filers. Thus, a trust that retains income may be subject to the investment surtax, whereas the same amount of income could instead be distributed to an individual beneficiary who would still be below the surtax threshold for individual taxpayers.

As such, trusts and estates have a strong incentive to distribute income so that it can be taxed in the generally lower tax brackets of individual beneficiaries.

Charitable Remainder Trusts. Taxpayers with charitable intent should consider establishing a charitable remainder trust (CRT). The CRT is a tax-exempt irrevocable trust that pays the taxpayer an income stream in exchange for a contribution of investment property. Upon the expiration of a set term, any property remaining in the CRT passes to charity.

In addition to a charitable deduction equal to the present value of the charity's interest in the year the CRT is established,[36] the taxpayer can shelter net investment income while smoothing modified AGI over an extended period of time. In so doing, the CRT can be used to help taxpayers keep modified AGI below surtax thresholds in any given year.

As a tax-exempt trust, the CRT can also sell donated property without incurring any capital gains tax, thereby allowing it to reinvest the proceeds.[37] This, for taxpayers subject to the investment surtax, makes CRTs attractive because they can unlock cash flow from stagnant assets or diversify concentrated equity portfolios while reducing tax.

Conclusion

Though it is never too late to plan, the strategies presented in this article deserve immediate consideration in light of the year-end legislative imperative.

Of course, it may be that Congress and the president will extend the reduced rates of the Bush era and lessen the impact of the investment surtax. But it is at least as likely that this extension will not occur.

Either way, the investment surtax is coming and there is no better time to plan for it than today.

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180 days of the closing on the initial property sold. The taxpayer must then make sure to provide a specific written identification of potential replacement property to the qualified intermediary within 45 days of the date of sale.

[32] I.R.C. Section 1031(a)(2).

[33] Generally, gifts of financial assets to children will cause them to be subject to income tax on the future earnings of those assets. An exception to this general rule is the ''kiddie tax,'' which will subject children to their parent's tax rates on a certain amount of investment income. The kiddie tax applies to children under 18 and to 18-year-olds if their earned income does not exceed half of the amount of their support. It also applies to children between the ages of 19 and 23 if they are full-time students and their earned income does not exceed half of the amount of their support.

[34] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Section 302(a)(1).

[35] Collins, Margaret, ''Obama Victory Leads Wealthy to Make Quick Pre-2013 Moves,'' *Bloomberg Businessweek*, Nov. 8, 2012, http://www.businessweek.com/news/2012-11-08/obama-victory-leads-wealthy-to-make-quick-pre-2013-moves#p1.

[36] When a qualified charitable remainder trust is created, a current tax deduction is allowed for the value of the charitable remainder interest (except in certain situations involving funding the trust with tangible personal property). SeeI.R.C. Section 170(a)(3). The method of computing the deduction is described in Reg. Section 1.664-4.

[37] I.R.C. Section 664(d).