Planning for the New 3.8-Percent Surtax

By Robert S. Keebler, CPA, MST, AEP®, and Peter J. Meicher, JD, LLM

The Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) created a 3.8-percent surtax on certain passive investment income and is scheduled to go into effect for tax years beginning in 2013. This article explains how the surtax works and suggests planning strategies that could provide important tax savings.

Background
New Internal Revenue Code (IRC) Section 1411 imposes a 3.8-percent surtax on the lesser of 1) a taxpayer’s net investment income (NII) or 2) the excess of a taxpayer’s modified adjusted gross income (MAGI) over an applicable threshold amount. Before proceeding to an explanation of how the tax is calculated and how tax savings can be created, it is important to define the terms.

Net Investment Income
IRC Section 1411 specifically lists items of income that are subject to the surtax and excludes others. Investment income includes:
- Dividends
- Interest
- Rents
- Capital gains
- Annuities
- Passive activity income
- Royalties

Investment income does not include:
- Active trade or business income
- Self-employment income
- Income of nonresident aliens
- Gain on the sale of an active interest in a partnership or S corporation
- Individual retirement account (IRA) or qualified plan distributions
- Trusts for charity (except charitable lead annuity trusts)
- Under the active trade or business exclusion, dividends, interest, rents, 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 engaged in an active business, NII includes only nonbusiness income from these sources.

Modified Adjusted Gross Income
On page one of Form 1040, taxpayers calculate their total income minus certain tax-exempt items such as tax-exempt interest or nontaxable distributions from a Roth IRA. The result is entered at the bottom of the page as adjusted gross income (AGI). Modified adjusted gross income is AGI plus the net amount excluded as foreign earned income under IRC Section 911(a)(1). Because most clients do not have foreign earned income, MAGI generally will be the same as AGI.

Threshold Amounts
The applicable threshold amounts are based on filing status as shown below.
- Married taxpayers filing jointly: $250,000
- Married taxpayers filing separately: $125,000
- All other individual taxpayers: $200,000

Special Rules for Trusts
The surtax amount for 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 and will be indexed for inflation thereafter.

Calculating the Tax Payable
Calculation of the surtax payable is best illustrated through a series of examples.

Example 1. Bart, a single taxpayer, has $115,000 of salary income and $70,000 of NII in 2013. The surtax applies to the lesser of 1) NII ($70,000) or 2) the excess of Bart’s MAGI over the threshold amount of $200,000 for a single taxpayer. Because Bart’s income is less than $200,000, the excess amount is zero so no surtax is payable. Note that there never can be any surtax unless MAGI exceeds the applicable threshold amount.

Example 2. Richard and Jane, married taxpayers filing jointly, have $2 million of salary income and no NII. The surtax applies to the lesser of 1) NII ($0) or 2) the excess of $2 million over the threshold amount of $250,000 for married taxpayers filing jointly ($1,750,000). Thus, no surtax is payable. There never can be any surtax without NII regardless of how high MAGI is.

Example 3. Bill and Gretchen, married taxpayers filing separately, have $400,000 of salary income and $100,000 of NII. The amount subject to the surtax is the lesser of 1) NII ($100,000) or 2) MAGI minus the threshold amount for married taxpayers ($150,000). Thus, the amount subject to the tax is $100,000 and the surtax payable is $3,800 (0.038 x $100,000).

Example 4. Emma, a single taxpayer, has $170,000 of investment income and received a $50,000 required minimum distribution (RMD) from her traditional IRA. The RMD is included in MAGI, increasing it to $220,000. The surtax applies to the lesser of 1) NII ($170,000)
One implication of these rules is that taxpayers who otherwise would be subject to the surtax on distributions from their traditional IRAs can completely avoid the tax by doing a Roth IRA conversion before 2013.

or 2) the excess of MAGI over the applicable threshold amount ($20,000). Thus, $20,000 is subject to the surtax and the amount of surtax payable is $760 (0.038 x $20,000).

Example 5. Ray, a single taxpayer, has $180,000 of salary income, $40,000 of interest income, $30,000 of tax-exempt income, and $10,000 of dividend income. This makes his MAGI $230,000 ($180,000 salary income + $40,000 interest income + $10,000 dividend income). The tax-exempt income is not included in MAGI. His NII is $50,000 ($40,000 interest income + $10,000 dividends). The surtax applies to the lesser of 1) NII ($50,000) or 2) the excess of MAGI over the applicable threshold amount for single taxpayers, or $30,000. The surtax payable will be $1,140 (0.038 x 30,000).

Example 6. Rose, 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 applicable $200,000 threshold amount. However, she decides to convert her $450,000 traditional IRA to a Roth IRA. The $450,000 is not treated as NII; it increases her MAGI to $650,000 and subjects all of Rose’s NII to the surtax.

Example 7. Warren (age 71) and Kay (age 65), married taxpayers filing jointly, have NII of $120,000 and salary income of $110,000 in 2013. Without additional income they would not be subject to the surtax because their MAGI does not exceed the applicable threshold amount of $250,000. Warren receives a $60,000 RMD from his traditional IRA. The distribution is not NII, but it increases MAGI from $230,000 to $290,000 and causes $40,000 of the NII to be subject to the surtax.

Example 8. Assume the same facts as in example 7 except that Warren 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 $230,000 and there is no surtax even though Warren and Kay have substantial NII.

Example 9. Assume the same facts as in example 8 except that the Roth conversion was not made until the beginning of 2013 and the amount of the conversion was $350,000. The conversion amount increases MAGI to $590,000 and makes the full $120,000 of NII subject to the surtax.

Example 10. Art’s estate 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 is $334 (0.038 x $8,800).

Example 11. Assume the same facts as in example 10 except that all the income is distributed. Under these facts, the income will be reported to the heirs and there will be no surtax exposure for the estate.

Strategies for Reducing the Surtax

The following 11 strategies can be used to reduce NII and/or MAGI and reduce the surtax.

1. 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.

One implication of these rules is that taxpayers who otherwise would 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 12. 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.

Before deciding on a current Roth conversion, however, taxpayers should do a comprehensive mathematical analysis to make sure it provides an overall economic benefit and not just savings on the surtax. While such an analysis is beyond the scope of this article, note that one of the key variables favoring a Roth conversion is a lower tax rate at the time of conversion than when distributions are received. The surtax and scheduled increase in rates for 2013 make it much more likely that a high-income taxpayer will have a lower rate for a 2011 conversion than she would have on later distributions from a traditional IRA. For such taxpayers, the difference in marginal tax rates
between converting to a Roth IRA in 2011 and paying income tax plus surtax on traditional IRA distributions in 2013 and later years could be as much as 8.4 percent \([(39.6\% + 3.8\%) – 35\%]\).

2. Tax-Exempt Bonds
Interest on corporate bonds is NII, but interest on tax-exempt bonds is not. This means that taxpayers with corporate bonds may be able to reduce their surtax exposure by switching from corporate bonds to tax-exempt bonds. Just because this would save on surtax, however, doesn't necessarily mean that it would be a good idea. The bottom line on taxable bond investments is after-tax return as a good idea. The bottom line on taxable doesn't necessarily mean that it would be this would save on surtax, however, may be able to reduce their surtax on traditional IRA distributions in 2013 and later years could be as much as 8.4 percent \([(39.6\% + 3.8\%) – 35\%]\).

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Example 13. Helen, a single taxpayer in the 39.6-percent marginal tax bracket in 2013, owns $100,000 of corporate bonds that produce income at 6.0 percent. After taking the 3.8-percent surtax into account, her effective tax rate is 43.4 percent (39.6 + 3.8). This leaves 56.6 percent after tax (100% – 43.4%). Thus, her after-tax rate of return is 6.0 x 0.566 = 3.396 percent. Switching to bonds would make sense if she can earn an interest rate in excess of 3.396 percent. Note that the higher the effective tax rate, the lower the break-even interest rate for tax-exempt bonds would be.

3. 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 any given year, the intangible drilling costs associated with oil and gas investments can produce a large current deduction. This deduction may be as much as 80 percent of the amount invested in a well.

4. Life Insurance
A similar income-smoothing result can be produced by purchasing a whole life insurance policy. The taxpayer can reallocate money from assets producing current NII and/or MAGI to assets that are creating neither. The taxpayer then could withdraw earnings from the policy in lower-income years.

5. Rental Real Estate
NII includes only net investment income. This means that investment losses can reduce investment income from an activity and 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 such as interest.

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

7. 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 a tax year beginning in late 2012 rather than early 2013 it may be able to realize significant tax savings.

Example 14. Bill and Susan, married taxpayers filing jointly, are in the 39.6-percent 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 oil well. The investment produces the following tax benefits:

- 2013 income tax deduction: $31,680 (0.8 x 0.396 x $100,000)
- Surtax savings: $3,040 (0.8 x 0.038 x $100,000)
- Total tax savings: $34,720

8. 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 avoided by distributing enough of the net income to reduce undistributed income to less than $11,200.

9. Charitable Remainder Trusts
The surtax does not apply to charitable remainder trusts. This means that if a taxpayer contributed appreciated capital gain property to a charitable remainder trust, the trust could sell the property without paying any surtax. Moreover, the gain would have no immediate effect on the grantor’s MAGI. The taxpayer would have no MAGI until he received 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.

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

11. Above-the-Line Deductions
Deductions that can be claimed on page one of Form 1040 reduce MAGI without necessarily reducing NII. Two of the most important are contributions to qualified plans and traditional IRAs and charitable contributions.

Conclusion
Without planning, the new 3.8-percent surtax could significantly increase the tax payable by high-income individuals and trusts beginning with the 2013 tax year. Fortunately, a number of effective tax strategies can be employed, particularly in 2011 and 2012, that can reduce or eliminate exposure to the surtax.

Robert S. Keebler, CPA, MST, AEP® (Distinguished), is a partner with Keebler & Associates, LLP in Green Bay, WI. He frequently represents clients before the IRS in the private letter ruling process and in estate, gift, and income tax examinations and appeals. He earned a BS in accounting from Lakeland College and a MST from the University of Wisconsin-Milwaukee. Contact him at robert.keebler@keeblerandassociates.com.

Peter J. Melcher, JD, LLM, is a consultant with Keebler & Associates, LLP, where he specializes in tax planning for high-net-worth individuals. He earned a JD from the University of Wisconsin, an LLM from DePaul University, and an MBA from The University of Chicago. Contact him at peter.melcher@keeblerandassociates.com.

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