

2010 Healthcare Reconciliation Bill Tax Provisions

I. OVERVIEW OF NEW TAX

- A. A new 3.8% Medicare tax is assessed on the lesser of:
1. “Net investment income” OR
 2. The excess of “Modified Adjusted Gross Income” (MAGI) over the “threshold amount”
- B. “*Net investment income*” – is the sum of gross investment income over allocable investment expenses
1. “Investment income” (for purposes of the 3.8% tax) includes:
 - a. Interest
 - b. Dividends
 - c. Capital gains
 - d. Annuities
 - e. Rents
 - f. Royalties
 - g. Passive activity income
 2. “Investment income” does not include:
 - a. Active trade and/or business income
 - b. Any of the above sources of income in “B1” above (e.g. interest, dividends, capital gains, etc.) to the extent it is derived in an active trade and/or business
 - c. Distributions from IRAs or other qualified retirement plans
 - d. Any income taken into account for self-employment tax purposes

3. Other limitations on “investment income”

a. Gain on sale of an active interest in a partnership or S-corporation

- i. Gain included as “investment income” is limited to the net gain that would be recognized if all of the partnership/S-corporation interests were at fair market value (FMV)

C. “*Modified Adjusted Gross Income*” (MAGI) – is the sum of adjusted gross income (i.e. 2009 Form 1040, Line 37) plus the net foreign income exclusion amount

D. “*Threshold amount*”

1. Married taxpayers filing jointly – \$250,000
2. Married taxpayers filing separately – \$125,000
3. All other individual taxpayers – \$200,000
4. Trusts and estates - \$11,200

E. Effective tax rate

1. 39.6%
2. 3.8% Surtax rate
3. Total rate up to 43.4%

II. WHO DOES THE NEW TAX AFFECT?

A. $MAGI \leq$ “threshold amount” = No application of 3.8% Medicare tax

B. $MAGI >$ “threshold amount” = Possible application of 3.8% Medicare tax

C. Examples

1. John, single, has \$100,000 of salary and \$50,000 of net investment income
 - a. 3.8% Medicare tax would not apply ($MAGI < \$200,000$)

2. Mary, single, has \$225,000 of net investment income and no other income
 - a. The 3.8% Medicare tax would apply to \$25,000 of income (excess of \$225,000 MAGI over \$200,000 “threshold amount”)
3. Terry and Tina, married filing jointly, have \$300,000 of salaries and no other income
 - a. The 3.8% Medicare tax would not apply (no net investment income)
4. Peter and Paula, married filing jointly, have \$400,000 of salaries and \$50,000 of net investment income
 - a. 3.8% Medicare tax would apply to \$50,000 of net investment income
5. Scott and Sarah, married filing jointly, have \$200,000 of salaries and \$150,000 of net investment income
 - a. 3.8% Medicare tax would apply to \$100,000 of income (excess of \$350,000 MAGI over \$250,000 “threshold amount”)

III. PLANNING CONSIDERATIONS

A. Qualified retirement plans – reduce MAGI

1. Contributions to 401(k) plans, 403(b) plans, 457 plans, IRAs, etc.
2. Creation of “alternative” qualified retirement plans (e.g. defined-benefit plans)
3. Roth conversions – 2010 through 2012
 - a. Today’s top rate is 35.0%
 - b. 2013’s top rate is 43.4%
 - c. Arbitrage of 8.4%

B. Tax-exempt/tax-deferred investments/timing – Reduce MAGI and investment income

1. Municipal bonds – remain tax exempt
 - a. Critical for trusts
 - b. 43.4% effective rate on corporate taxable bonds
 - c. Arbitrage will change

2. Tax-deferred non-qualified annuities – during deferral
 - a. Income is deferred
 - b. “Leapfrog” over high income years
 - c. Part of MAGI and investment income later
 3. Non-Qualified Deferred Compensation (NQDC)
 4. Life insurance
 - a. MEC policies
 - i. earnings withdrawal first
 - ii. no policy loans
 - b. Non-MEC policies
 - i. Basis is withdrawn first
 - ii. Loans are not taxable
 - c. No taxable income at death
 5. Oil and gas investments
 - a. IDC deductions
 - b. Depletion allowances
 6. Real estate investments
 - a. Depreciation tax shield
 7. Timing of 2012 bond income
 - a. Accelerate bond interest income into 2012
 - i. Timing of interest payments (focus on December 2012 payments)
 - ii. Sell “ripe” bonds in late December 2012
 - iii. Repurchase different bonds in January 2013
 8. Security sales
 - a. Accelerate gains into 2012
 - b. Collar gains and slowly sell
 - c. Merger shorts to generate capital losses
 9. Dividend income
 - a. Timing of dividends
 - b. Return of capital dividends
 10. Installment sales
 - a. Defer recognition of income over a period of time (to get under the MAGI threshold)
- C. Estates and electing trusts must select the proper year to reduce the surtax

D. Roth IRA conversions

1. Roth IRA distributions will not count towards MAGI
2. Roth IRA conversion income does count towards MAGI
3. Payment of income tax using non-qualified accounts (i.e. “outside assets”) will generally result in lower future “net investment income”
4. The “Surtax Bubble” is a key concern
 - a. RMDs from Traditional IRAs
 - i. Exempt from the surtax
 - ii. Increase MAGI
 - iii. Creates a 43.4% effective tax rate on IRA distributions
5. Future tax rates are shown below:

<i>Taxable Income</i>	<i>2010</i>	<i>2011</i>	<i>Top Rate with Surtax 2013¹</i>
\$ 0 – 16,750	10%	15%	15%
\$ 16,750 – 68,000	15%	15%	15%
\$ 68,000 – 137,300	25%	28%	28%
\$ 137,300 – 209,250	28%	31%	34.8%
\$ 209,250 – 373,650	33%	36%	39.8%
Over \$373,650	35%	39.6%	43.4%

6. Because of the expiration of the Bush administration tax cuts, the Roth opportunity should be explored in the next nine months.

¹ The top rate with surtax in 2013 is simply the rate shown for 2011 in addition to the surtax rate of 3.8%.

E. Charitable trusts

1. Charitable remainder trusts (CRTs)
 - a. Defer recognition of income over a period of time (to get under the MAGI threshold)
 - b. Smooth out spikes in income
 - c. Exempt from the surtax
2. Non-grantor charitable lead trusts (CLTs)
 - a. Shift income away from grantor to trust – reduce MAGI
 - b. More tax efficient under the MAGI computation formula
 - c. Charitable deduction is “above” the line

Email lisa.chapa@bakertilly.com to be added to our newsletter for previous write-ups about the new IRA developments, or for information about seminars, CDs or books. Lisa can also be reached at 1 920 739 3361.

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