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MEMORANDUM

SUBJECT: PREPARING FOR THE NEW 3.8% MEDICARE TAX

DATE: DECEMBER 3, 2012

The Health Care and Education Reconciliation Act of 2010 (the Health Care Act) imposes a new 3.8% Medicare tax on investment income for individuals, trusts and estates. This new surtax is scheduled to begin in 2013. We have provided below a summary of the impact to individuals, trusts and estates. In addition, we have provided potential planning strategies to lessen the burden of the surtax on your investment income.

Individual Application

This surtax is assessed in addition to the regular Federal income tax and alternative minimum tax on the individual tax return. The surtax will also need to be taken into account for estimated tax purposes as well as computing the penalty for underpayment of the estimated tax.

For individual taxpayer's the surtax is equal to the 3.8% of the lesser of:

- Net investment income or
- The excess of modified adjusted gross income over a threshold amount

Net investment income is defined as the excess of gross investment income over investment deductions. Gross investment income includes interest, dividends, capital gains, annuities, rents and royalties. Further, net investment income also includes income from a passive activity or a trade or business of trading in financial instruments or commodities. Hedge fund income is also included, as are taxable gains from the sale of a personal residence in excess of the amount allowed under Internal Revenue Code as an exclusion.

Net investment income does not include the following: income from an active trade or business, distributions from an IRA or other qualified retirement plan, distributions from qualified annuity plans, tax-exempt interest, veteran benefits or income subject to self-employment tax.Modified adjusted gross income "MAGI" is the taxpayer's adjusted gross income plus the net foreign income exclusion amount.

The "threshold amount" is:

- For married taxpayers filing jointly - $250,000
- For married taxpayers filing separately - $125,000
- For all other individual taxpayers - $200,000

Again, the 3.8% surtax applies to the lesser of (i) net investment income or (ii) the excess of MAGI over the threshold amount. To clarify, below are a few examples of the calculation:

Example 1: Single taxpayer has net investment income of $300,000 and no other income. The 3.8% surtax applies to $100,000 of income (the excess of his MAGI over the threshold amount).

Example 2: Single taxpayer has salary income of $50,000 and net investment income of $60,000. The 3.8% surtax does not apply because the taxpayer's MAGI of $110,000 does not exceed the threshold amount.

Example 3: Married taxpayers (filing jointly) have $200,000 of salary income and $350,000 of net investment income. The 3.8% surtax applies to $300,000 (the excess of the taxpayer's MAGI over the threshold amount).

Example 4: Married taxpayers (filing jointly) have $700,000 of salary income and $40,000 of net investment income. The 3.8% surtax applies to the $40,000 of net investment income (which is less than the excess of the MAGI over the threshold amount).

Trust and Estate Application

The 3.8% surtax will also be imposed on the net investment income of both estates and trusts. The surtax will not apply to trusts in which all the unexpired interests are devoted to charitable purposes, or to tax-exempt trusts or charitable remainder trusts. The surtax would apply to non-grantor charitable lead trusts to the extent the trust income is not annually distributed to a charity.

For a trust or estate, the tax is equal to 3.8% of the lesser of:

- Undistributed net investment income
- The excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to a trust or estate begins.

For 2012 the highest trust and estate income tax bracket begins at only $11,650. Therefore, the 3.8% surtax applies to trusts and estates at a much lower income level than it does individual taxpayer's.

The 3.8% tax will not apply at the trust level to net investment income that is distributed by an estate or trust, as these distributions would be taxed on the beneficiary's individual tax return. One potential planning strategy would be to distribute all of the taxable income (interest, dividends, rent income) annually to the beneficiaries. Even though these distributions would be taxable to the beneficiaries they may not have reached the threshold for purposes of calculating the 3.8% surtax on the individual level.

Planning Strategies

Taxpayers should begin planning now to avoid or reduce the impact of the new Medicare surtax on their investments. Some potential strategies include:

- Maximize the investments in qualified retirement plans (401k, IRA, etc), which will protect future savings since the 3.8% tax is not imposed on income withdrawn from such accounts

- Consider investing in tax-exempt bonds, which are exempt from the 3.8% surtax. This may be most useful for estates and trusts since they are subject to the additional tax at a low income level.

- Rental real estate with the potential for depreciation deductions and working interests in oil and gas interests might also be a good investment to consider

- Consider selling appreciated assets in a portfolio before December 31, 2012. The gains will be subject to income or capital gains tax, but would not be exposed to the 3.8% additional surtax. Similarly, you could consider accelerating bond interest to 2012 and repurchase different bonds in 2013.

- Maximize above the line deductions (health savings account, self-employed retirement account, and traditional IRA's. These deductions reduce the MAGI.

- For future planning, consider the use of charitable trusts. As mentioned previously, a charitable remainder trust is exempt from the 3.8% tax and enables the taxpayer to defer recognition of income over a period of time, which ultimately gives the taxpayer more flexibility in keeping the MAGI under the threshold amount.

- Use caution when considering the selection of a fiscal year for an estate or electing trust.

- Rental income is subject to the 3.8% surtax unless it is derived in the ordinary course of a trade or business. Real estate investors should review the active real estate investor rules to determine if they might qualify as an active participant, thus, avoiding the 3.8% surtax.

Conclusion

The above summary is intended to be used as a general summary of the new surtax starting in 2013. Please do not hesitate to contact our office if you have any specific questions or concerns.