Are you Prepared for 2013??

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May 2012

Changes are coming, and not all of them are good. Proper tax planning, sooner rather than later, will prepare you and avoid unpleasant surprises when you file your 2013 tax returns. In addition to changes, there are also two new taxes that will be applicable on your 2013 income.

The health care reform legislation enacted in 2010 broadens the Medicare tax base for higher-income taxpayers (the two new taxes previously referenced). Beginning in 2013, higher-income taxpayers will be subject to (1) an additional 0.9% tax on earned income and (2) a new 3.8% tax on investment income.

New HI tax on net earned income

Currently, there is imposed on the income of every individual, a tax equal to 1.45% of the wages received with respect to employment. Effective for tax years beginning after December 31, 2012, an additional 0.9% hospital insurance (HI) tax will be imposed on wages in excess of $250,000 for married taxpayers filing a joint return, $125,000 for married taxpayers filing separately, and $200,000 for single or head of household taxpayers. This additional 0.9% HI tax is also imposed on an individual's net earnings from self-employment in excess of the above threshold amounts.

When a taxpayer has both wages and net earnings from self-employment, the threshold amount for net earnings from self-employment is reduced (but not below zero) by the amount of wages taken into account in determining the additional tax on wages. The net effect of reducing the net earnings from self-employment threshold by the wages taken into account in determining the additional tax on wages is to subject the total amount of earned income (wages and net earnings from self-employment) in excess of the appropriate threshold to the additional tax.

Basically, the additional tax on wages increases the employee portion of HI tax to 2.35% (1.45% + 0.9%) for taxpayers with earned income in excess of the threshold amount. The employer matching tax remains unchanged at 1.45%. The net effect of the additional tax on net earnings from self-employment is to increase the HI tax on net earnings from self-employment to 3.8% (2.9% + 0.9%) for taxpayers with earned income in excess of the threshold amount.

Although employers are not subject to the matching excise tax, they do have a withholding obligation. For employ*ers* who fail to deduct and withhold the appropriate amount of tax, and the tax is imposed on and paid by the employ*ee*, the tax that was required to be deducted and withheld shall not be collected from the employer. However, the employer will remain liable for any penalties or additions to tax applicable due to their failure to deduct and withhold the appropriate taxes.

The additional 0.9% HI withholding tax shall only apply to the taxpayer wages from their employer in excess of $200,000, and the employer may disregard the amount of wages received by the taxpayer's spouse.

Unlike the 1.45% HI tax, which is applied separately to wages earned by each spouse, the new 0.9% HI tax is imposed on combined wages in excess of $250,000 for married taxpayers filing a joint return. Because the $250,000 threshold for married taxpayers is less than twice the $200,000 threshold for unmarried taxpayers, married taxpayers are potentially subject to a "marriage penalty."

The threshold amounts for the additional HI tax are not adjusted for inflation. It is likely that more taxpayers will become subject to this tax in the future.

New HI tax on net investment income

Effective for tax years beginning after December 31, 2012, higher-income taxpayers with investment income will be subject to a new 3.8% Unearned Income Medicare Contributions Tax (UIMCT) on their net investment income. HI tax has traditionally been imposed only on wages and net earnings from self-employment. The UIMCT extends HI tax to investment income.

The UIMCT is imposed on the lesser of (1) net investment income, or (2) the excess of modified adjusted gross income over a threshold amount. The threshold amounts are the same as those used for the additional 0.9% HI tax ($250,000 for married couples filing a joint return; $125,000 for married couples filing separately; and $200,000 for all other taxpayers). As is the case with the additional 0.9% HI tax, these threshold amounts are not indexed for inflation.

Taxpayers are subject to the UIMCT on the full amount of net investment income only if their modified adjusted gross income exceeds the threshold amount by at least the amount of net investment income. Taxpayers can be subject to both the additional 0.9% HI tax on earned income and the UIMCT in the same year.

Modified adjusted gross income is defined as adjusted gross income increased by foreign earned income or housing costs excluded from income, reduced by deductions attributable to the excluded income. Net investment income is defined as the excess of the sum of the following items less deductions properly allocable to such items:

› Gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the UIMCT tax does not apply

› Income from a trade or business to which the UIMCT tax does not apply

› Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the UIMCT does not apply

The UIMCT applies to a trade or business that is a passive activity with respect to the taxpayer, and the trade or business of trading in financial instruments or commodities. Business income from an activity that is passive with respect to the taxpayer is considered investment income for purposes of the UIMCT.

The tax does not apply to active trade or business activities conducted by a sole proprietor, partnership, or S corporation. Income from active business activities, however, is included in net earnings from self-employment and therefore subject to the additional 0.9% HI tax. Investment income does include income from the investment of working capital.

Therefore, a gain from the disposition of an interest in a partnership or S Corporation is included in net investment income only to the extent of the net gain the transferor would take into account if the partnership or S Corporation sold all of its assets for fair market value immediately before the disposition.

Distributions from the following retirement plans are excluded from net investment income:

› Qualified pension, profit-sharing, and stock bonus plans

› Quality annuity plans

› Qualified plans for tax-exempt organizations

› Individual retirement accounts (IRAs) and ROTH IRAs

› Deferred compensation plans of state and local governments and tax-exempt organizations

Estates and trusts are subject to the unearned income Medicare contributions tax (UIMCT). The tax is imposed on the lesser of: (1) undistributed net investment income, or (2) the excess of the estate or trust's adjusted gross income over the dollar amount at which the highest tax bracket begins. Because the highest tax bracket for estates and trusts begins at a low level of income ($11,650 for 2012) the UIMCT should be of particular concern.

The UIMCT applies only to the *undistributed* net investment income of an estate or trust. If an estate or trust makes a distribution to beneficiaries, its undistributed net investment income (and potential liability for the UIMCT) decreases, while the beneficiary's net investment income (and potential liability for the UIMCT) increases. However, because the threshold amount for individuals is much higher than the threshold amount for estates and trusts*, a distribution will in all likelihood reduce the overall amount of UIMCT paid.*

WHAT DOES ALL OF THIS MEAN?

Tax planning techniques

You should begin planning for the UIMCT now in order to minimize its impact in 2013. The UIMCT, combined with the increase in the top marginal tax rate, will significantly increase the marginal tax rate that higher-income taxpayers pay on investment income.

The UIMCT applies only to taxpayers with both modified adjusted gross income above the threshold amount and net investment income. As a result, taxpayers can minimize its impact by minimizing either MAGI or net investment income (or both). Tax planning strategies include the following:

- **Income recognition and deferral planning**
  Items of income that are excluded from income reduce both modified adjusted gross income and net investment income. This provides higher-income taxpayers potentially subject to the UIMCT additional incentive to structure transactions that result in either tax-exempt or tax-deferred income. Higher-income taxpayers can minimize the UIMCT by including non-dividend paying growth stocks (which do not increase modified adjusted gross income or create investment income until sold) in their investment portfolios. Tax-deferred annuities and related investments will also minimize liability for the UIMCT, and may become more popular. Because tax-exempt income is not included in either modified adjusted gross income or investment income, higher-income taxpayers will have increased incentive to invest in exempt state and local obligations.

- **Capital gain planning**
  Investment income includes net gain (to the extent taken into account in computing taxable income) from the disposition of property. Tax planning strategies that reduce or defer capital gain income will also reduce or defer net investment income for purposes of the UIMCT. Using the installment method of accounting to report gain on the sale of property sold on an installment basis will minimize the impact of the UIMCT because it avoids a large increase in both modified adjusted gross income and investment income in the year of sale.

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

- **Retirement income planning**
  Because distributions from qualified retirement plans are not included in net investment income, the UIMCT provides taxpayers with additional incentive to maximize retirement plan contributions. Although retirement plan distributions are not included in net investment income, distributions that are included in income (such as those from a traditional IRA or 401(k)) increase modified adjusted gross income. This increase in modified adjusted gross income may increase the amount of other investment income subject to the UIMCT. On the other hand, retirement plan distributions that are not included in income (such as those from a Roth IRA or Roth 401(k)) do not increase modified adjusted gross income. This provides higher-income taxpayers with incentive to contribute to Roth-type retirement plans, rather than traditional plans. Contributions to traditional retirement plans reduce modified adjusted gross income in the year of contribution, while contributions to Roth plans do not. Taxpayers with modified adjusted gross income near the threshold level may be able to avoid or reduce current year's UIMCT by contributing to a traditional plan and reducing modified adjusted gross income below the threshold.

- **Passive activity loss planning**
  Passive income is investment income for purposes of the UIMCT. Classifying income as passive is generally advantageous for taxpayers with sufficient passive losses to offset the passive income. For taxpayers with net passive income, however, the UIMCT increases the tax rate on passive income.

- Estate planning
  The UIMCT provides higher-income taxpayers with an incentive to consider the use of family limited partnerships and related estate planning techniques. Investment income transferred from parents with significant MAGI and investment income to children with MAGI below the applicable threshold amount through the use of family limited partnerships will not be subject to the UIMCT. Although investment income transferred to children through a family limited partnership may be taxed at their parent's rate under the "kiddie tax" rules, the children will be subject to the UIMCT only if their income (including income from a family limited partnership) exceeds the applicable threshold. Children subject to the kiddie tax are taxed at their parent's rate for purposes of the regular tax. However, children will not be subject to the UIMCT merely because their parents are.

- Tax planning for estates and trusts
  Estates and trusts with undistributed net investment income will be subject to the UIMCT whenever their adjusted gross income exceeds the dollar amount at which the top marginal tax rate begins. Because the top marginal rate for estates and trusts begins at a relatively small amount of income ($11,650 in 2012), the UIMCT is of particular concern to estates and trusts and should be considered in both distribution and investment decisions. Estates and trusts are subject to the UIMCT only if they have undistributed net investment income. Estates and trusts can reduce undistributed net investment income and thereby minimize or eliminate the UIMCT by distributing income to beneficiaries. Any distribution will increase the beneficiary's net investment income and potential liability for the UIMCT. However, the threshold amount for individuals is much higher than that for estates and trusts, and the UIMCT can be eliminated if the beneficiary's modified adjusted gross income remains below the threshold amount. Estates and trusts should also consider the UIMCT in making investment decisions. The UIMCT increases the already existing incentives estates and trusts have to invest in tax-exempt and tax-deferred investments.

Should you have any questions related to this topic, feel free to contact Denise Holmes, CPA, Partner, or your Keiter Client Service professional for further clarification.

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