



# The Wealth Counselor

A monthly newsletter for wealth planning professionals

## Current Planning to Avoid the Future Health Care 3.8% "Surtax"

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A new 3.8% surtax on certain investment income starts January 1, 2013, as part of the health care reform act. While that's a couple of years away, it is not too early to start planning for it because there are some steps clients can take this year that will help reduce or even eliminate it.

In this issue of *The Wealth Counselor*, we present an overview of this surtax, explore what taxpayers it will affect, and give some planning ideas you can use now with your clients.

### Understanding the Tax

The 3.8% investment income surtax, also called the health care surtax or the Medicare tax, applies to tax years ending after December 31, 2012. The surtax is:

*For individuals, 3.8% of the lesser of:*

1. net investment income for such taxable year, or
2. the excess, if any, of
  - a. the modified adjusted gross income for the year, over
  - b. the threshold amount.

*For trusts and estates, 3.8% of the lesser of:*

1. the undistributed net investment income for the year, or
2. the excess, if any, of
  - a. the adjusted gross income (as defined in Code Section 67(e)) for the year, over
  - b. the dollar amount at which the highest tax bracket in Code Section 1(e) begins for the year (\$11,200 in 2010).

### Three Key Numbers

From [Scott Schrader](#)

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Mr. Schrader's practice is concentrated in the areas of estate planning and post-death administration, as well as estate litigation and disputes.

There are three numbers that determine how this surtax will affect a client.

### *1. Net Investment Income*

This is the sum of gross investment income over allocable investment expenses. For purposes of this surtax, investment income includes interest, dividends, capital gains, annuities, rents, royalties and passive activity income.

Investment income does **not** include active trade and/or business income; any of the income sources listed above (e.g., interest, dividends, capital gains, etc.) to the extent it is derived in active trade and/or business; distributions from IRAs and other qualified retirement plans; or any income taken into account for self-employment tax purposes.

For the sale of an active interest in a partnership or S-corporation, gain is included as investment income only to the extent net gain that would be recognized if all of the partnership/S-corporation interests were at fair market value.

### *2. Modified Adjusted Gross Income (MAGI)*

Here, MAGI is the sum of adjusted gross income (the number from the last line on page 1 of Form 1040) plus the net foreign income exclusion amount.

### *3. Threshold Amount*

Married taxpayers filing jointly . . . \$250,000  
Married taxpayers filing separately . . . \$125,000  
All other individual taxpayers . . . \$200,000  
Trusts and estates . . . Beginning of the top bracket (\$11,200 for 2010)

### ***Who Will Pay the New Surtax?***

Here's a quick formula to determine if the 3.8% surtax will apply:

1. MAGI less than or equal to threshold amount = No tax
2. MAGI greater than threshold amount = Tax is 3.8% of *the lesser of*
  - a. investment income or
  - b. MAGI - threshold amount

Note that the surtax liability is determined on income **BEFORE** any tax deductions (page 2 of Form 1040) are considered. As a consequence, a client with lots of deductions could be in the lowest tax bracket and yet have investment income that is subject to the surtax!

Also, because the capital gain rate will increase for high-income taxpayers to 20% in 2011, with the 3.8% surtax the total tax on capital gains can be 23.8% in 2013 and beyond.

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## **Conclusion**

Even though the 3.8% health care surtax will not go into effect until 2013, taxpayers who will be exposed to it should begin planning in 2010, especially if a Roth conversion is desirable. Now is the time to get organized and run the projections so you will be able to incorporate any changes in year-end planning for your clients.

**Commentary regarding the estate tax exemption for 2011:** It is looking more and more like the exemption will be \$1 million in 2011. However, there is still a possibility that it will be \$3.5 million. It is recommended that you start assessing your clients now to see which ones will be over the \$3.5 million exemption and start their planning now. You can also start a "second-tier list" of those who will have net estates of between \$1 million and \$3.5 million so that, in the event the exemption is \$1 million, you will already know which of your clients will need additional planning.

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You have received this newsletter because I believe you will find its content valuable, and I hope that it will help you to provide better service to your clients. Please feel free to [contact me](#) if you have any questions about this or any matters relating to estate or wealth planning.

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