Impact of New 3.8% Tax and Higher Rates

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Simplicity is the ultimate sophistication. It takes a lot of hard work to make something simple, to truly understand the underlying challenges and come up with elegant solutions. Steve Jobs.

I. OVERVIEW

Effective January 1, 2013, the Health Care and Education Reconciliation Act of 2010 created a new 3.8% surtax (the "3.8% Tax") on certain net investment income ("NII"). Effective on the same date, the American Taxpayer Relief Act of 2012 permanently extended the Bush-era tax cuts for most taxpayers while increasing the top tax rates (i) on ordinary income from 35% to 39.6% and (ii) on long-term capital gains and qualified dividends from 15% to 20%. The 3.8% Tax coupled with these increases in top rates will dramatically increase the tax that individuals, trusts, and estates with income over certain thresholds pay on investment income.

A. The tax on investment income. The Health Care Act generally imposes the 3.8% Tax on net unearned income, including passive income passed through to partners, members of LLCs taxed as partnerships, and S corporation shareholders, with income over certain thresholds.

1. For individuals, the 3.8% Tax applies at a threshold of $250,000 in the case of married taxpayers filing a joint return, $125,000 for married taxpayers filing a separate return, and $200,000 for all other individual taxpayers. These thresholds are not indexed.

2. For estates and trusts, the 3.8% Tax is imposed on a quite low threshold ($11,950 for 2013) which is the dollar amount at which the highest trust tax bracket begins for the taxable year. Therefore, both the 3.8% Tax and the top rates (39.6% and 20%) begin at this level of income.

3. NII generally includes gross income from interest, dividends, annuities, royalties, and rents other than such income derived in the ordinary course of a trade or business.

4. Additional Medicare Tax. For the first time in the history of Social Security, the Health Care Act subjects investment income to a special tax similar to the Medicare tax on earned income. As a result, all individuals, whether employees or self employed, will now pay a total of 3.8% in taxes on net investment income over the thresholds (e.g., $250,000 for married taxpayers and $200,000 a single taxpayer).

B. Higher income tax rates. Individuals with incomes over somewhat higher thresholds are now facing the higher top tax rates (39.6% on ordinary income and 20% on capital gains and qualified dividends). The 2013 thresholds for these top tax rates are $450,000 for married filing jointly and $400,000 for a single taxpayer. Indexed for inflation, these rates will be $457,000 and $406,750 for 2014.

C. **2013 tax increases.** The chart below demonstrates the dramatic increases in taxes from 13% to 59% which can apply to a complex trust from 2012 to 2013 without proactive planning. Although individuals have higher, two-tiered thresholds (shown below in brackets), they have the same increases above the thresholds.

	2012	2013 [Individual Thresholds]	Increase
Top rate on Ordinary Income	35% *Trust/Estate Threshold $11,650*	39.6% *Trust/Estate Threshold $11,950 [$450,000/ $400,000]*	13%
Top rate on Long-Term Capital Gains (LTCG) & Qualified Dividends (QD)	15% *Trust/Estate Threshold $11,650*	20% *Trust/Estate Threshold $11,950 [$450,000/ $400,000]*	33%
Net Investment Income Tax (3.8% Tax)	None	3.8% *Trust/Estate Threshold $11,950 [$250,000/ $200,000]*	N/A
Top rate on ordinary income plus the 3.8% Tax	35%	43.4%	24%
Top rate on LTCG & QD plus the 3.8% Tax	15%	23.8%	59%

The wide disparity between the thresholds for trusts versus individuals creates excellent opportunities for reducing or eliminating these taxes for trusts and beneficiaries.

II. TAX PLANNING STRATEGIES

So what worthwhile planning opportunities should be considered?

A. For everyone over the applicable threshold, consider the following:

1. Using tax-exempt investments (more attractive now due to higher tax rates);
2. Taking advantage of tax-deferred investments such as life insurance and annuities;

3. Using recognition deferral techniques such as tax-free exchanges and installment sales; and

4. Harvesting capital losses to offset gains (even more beneficial than before).

B. For trusts and estates, consider:

1. Distributing income to beneficiaries to shift income to individuals with higher thresholds (while carefully considering fiduciary duties);

2. Including capital gains in distributed income (can be complicated);

3. Adopting or modifying investment policy to consider low turnover (to reduce capital gains);

4. Using grantor trusts (to use the grantor's higher thresholds) and charitable remainder trusts (exempt from these taxes at the trust level); and

5. Having a trust materially participate in the activities of the trust (to convert passive to active income).

III. CONCLUSION

The new 3.8% Tax and higher top income tax rates can increase combined federal taxes by up to 59%, creating even more incentive to consider tax-planning opportunities. This is especially true for trusts and estates. Since many of the techniques are somewhat complicated, we recommend that you consult with us or another tax advisor to determine what will work best for you.

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