New Medicare Taxes on the Horizon

Changes for higher-income taxpayers take effect in 2013

Begin planning now

You'll especially want to discuss these tax provisions with your Financial Advisor and tax advisor if you:

- Are considering retirement in the near future
- Anticipate receiving substantial deferred compensation or other taxable income in the coming years
- Will generate substantial investment income in the future
- Will withdraw taxable distributions from a traditional IRA in 2013 or later
- Expect substantial income in 2013 or later from the sale of a business or a Roth coversion

The 2010 health care reform act included these two key tax provisions that become effective in 2013 and affect higher-income taxpayers:

- A 0.9% increase in Medicare taxes on earned income (including net self-employment income) above $200,000 (individual filers) or $250,000 (married/joint filers)
- A 3.8% Medicare tax on investment income if your modified adjusted gross income (MAGI)* exceeds those same thresholds

Calculating the amount of additional taxes you may owe will be complex because multiple calculations may be required. (To get an idea of what will be involved, see the examples on page 4.)

Medicare tax rate summary

Thresholds for new taxes†

Single:	$200,000
Married filing jointly:	250,000

Employee compensation *Medicare wages as reported on IRS Form W-2*	Current rate	Rate effective 2013
Employee's tax rate up to threshold	1.45%	1.45%
Employee's tax rate in excess of threshold	1.45	2.35
Employer's tax rate (no threshold)	1.45	1.45
Self-employment income *Net self-employment income as determined on IRS Form 1040 Schedule SE*		
Owner's tax rate up to threshold	2.90	2.90
Owner's tax rate in excess of threshold	2.90	3.80
Investment income *Compare threshold to your MAGI as determined on IRS Form 1040*		
Investor's tax rate up to threshold	0.00	0.00
Investor's tax rate in excess of threshold	0.00	3.80

†These thresholds are not indexed for inflation. An increasing number of taxpayers could be subject to this tax increase as inflation boosts wages over time.

Note that many details regarding these two taxes are still unclear, and clarifications based on IRS technical guidance (yet to come) could affect certain strategies. Nonetheless, the remainder of this report will focus on the details and potential effects of these two tax provisions.

**MAGI is your adjusted gross income shown on page 1 of IRS Form 1040 plus any foreign income or foreign housing costs that were excluded from your income.*

Understanding the Medicare tax on earned income

Starting in 2013, employers will be required to withhold additional Medicare taxes once an employee's earned income exceeds $200,000. However, if you are married and both you and your spouse are highly compensated, the amounts your respective employers withhold may not cover your total tax bill. This could leave you unexpectedly owing additional taxes and penalties when you file your return. Consider this example:

> Spouse A earns $200,000 and Spouse B earns $100,000 in 2013. Each of their employers views its employee as having earnings at or below the $200,000 applicable threshold and, therefore, does not withhold the additional 0.9% tax. However, the couple's combined income ($300,000) does, in fact, exceed the threshold. As a result, the couple is subject to the tax on the $50,000 excess and will owe additional taxes, which will become apparent when they prepare their 2013 tax return.

Conversely, married couples with one salary with income exceeding $200,000 may overpay on the 0.9% tax. The employer must withhold the additional 0.9% tax based on the salary in excess of $200,000. However, the married couple is subject to the additional tax only on salary in excess of $250,000. The additional tax on amounts in excess of $200,000 but not in excess of $250,000 would result in excess withholding that would be realized upon the filing of the couple's income tax return for the year.

If you find yourself in either situation, you'll need to work closely with your tax advisor to determine whether to make quarterly estimated payments or have your employer withhold more or less from regular paychecks.

Self-employed individuals will also have to pay the additional 0.9% tax on their net self-employment income that exceeds the threshold. In general, self-employed individuals are allowed an income tax deduction on one-half of the self-employment taxes paid. However, the new law does not provide a deduction for any portion of the additional 0.9% tax.

What you should do now

To be prepared for the implementation of the new tax, make projections now regarding your expected income during the next several years. If you have flexibility in terms of when you receive certain income payments, you may want to consider timing those cash flows accordingly. Keep in mind that the application and timing of Medicare taxes can be complex depending on the type of compensation benefits you receive. Before implementing any planning ideas, talk with your employer and tax advisor.

Three types of investors will particularly want to factor this additional tax in their planning strategies:

Pre-retirees. As you transition into retirement, your compensation may change. You may be gradually reducing your workload and earnings over more than one year. Or your stock-based compensation may continue vesting beyond your retirement year (thus boosting taxable income into future years).

As you look toward 2013, you'll want to factor these tax consequences into the timing of your retirement. You may want to arrange your retirement date to ensure that any sizable income flow occurs before 2013. If you have an arrangement that allows for income streams over several years, you may want to accelerate that income into a year prior to 2013 rather than stretching it over multiple years.

Employees with sizable company stock benefits. If you are holding nonqualified stock options (NSOs) that will create taxable income when exercised, you'll want to discuss the timing of those exercises with your Financial Advisor and tax advisor to help reduce the tax liability. It may be worth exercising sooner than you expected to avoid the additional 0.9% tax and the effect on your MAGI, which could also increase and trigger the 3.8% tax on investment income.

Self-employed persons. You will want to look particularly at your expected income and expenses in 2012 and 2013. Work closely with your tax advisor to analyze whether you should accelerate or defer certain expenses to control your taxable income in 2013 and thereafter.

Focusing on the Medicare tax on investment income

There are three key points to understand about this new tax:

- It will be in addition to and calculated separately from your regular tax or alternative minimum tax (AMT) liability.
- The tax will apply to the lesser of your net investment income or the excess of your MAGI above the thresholds.
- Taxpayers should be aware of how investment income is calculated.
  - Net investment income will include:
    - Taxable interest
    - Dividends
    - Capital gains
    - Taxable annuity distributions
    - Rents and royalties received as passive income
  - Net investment income will *not* include:
    - Tax-exempt interest
    - Distributions from IRAs and employer plans
    - Income from an active trade or business

It's also important to note that there is no provision to automatically withhold this tax. You and your tax advisor will need to determine whether you should adjust withholding amounts or begin (or increase) estimated tax payments to avoid underpayment penalties.

Trusts and estates need to pay special attention

Trusts* and estates will also be subject to this new tax on investment income. However, the tax for these entities is determined differently than for individuals. Trusts and estates will be subject to tax on the lesser of their undistributed net investment income or the excess of their adjusted gross income over the threshold.

** Certain trusts may be exempt. Consult your tax advisor.*

A look at the effect in 2013 on three taxpayers

Bob and Theresa *(married filing jointly)*

Combined wages *(Under the threshold for the 0.9% earned income tax)*	$230,000
Capital gains	30,000
MAGI *(Over the threshold for the 3.8% investment income tax)*	$260,000

The additional tax on investment income would apply to the lesser of:

Net investment income *or*	$30,000
Excess MAGI over $250,000 threshold	10,000

In this example,
Bob and Theresa will pay 3.8% on $ 0,000, or an additional tax of $380.

Martha *(single)*

Wages	$180,000
Dividends	20,000
MAGI *(Under the threshold for the Medicare tax on both earned income and investment income)*	$200,000

However, Martha decides to take a fully taxable $30,000 IRA distribution:

IRA distribution	$ 30,000
New MAGI *(Over the threshold for the 3.8% tax on investment income)*	230,000

The additional Medicare tax would apply to the lesser of:

Net investment income *or*	$20,000
Excess MAGI over $200,000 threshold	30,000

In this example,
Martha will pay 3.8% $20,000, or an additic of $760.

It's important to understand that although IRA distributions are excluded from investment income for purposes of calculating the tax, the distributions boost MAGI, which can subsequently subject a taxpayer to the 3.8% Medicare tax.

David and Elizabeth *(married filing jointly)*

Combined wages *(Over the threshold for the 0.9% tax on earned income)*	$350,000
Dividends and capital gains	35,000
MAGI *(Over the threshold for the 3.8% tax on investment income)*	$385,000

The additional tax on earned income would be:

Wages ($350,000) – threshold ($250,000) = $100,000 x 0.9% = $900

The additional tax on investment income would apply to the lesser of:

Net investment income *or*	$ 35,000
Excess MAGI over $250,000 threshold	135,000

In this example,
David and Elizabeth will pay an additional $900 on earned income plus $,330 on net investment income (3.8% tax on $35,000) for a total additional Medicare tax of $2,230.

As you can see, you and your tax advisor will need to pay close attention to both your projected MAGI and net investment income. You'll want to involve both your tax and financial advisors in discussions on realizing capital gains or other types of income as these will affect the calculation of both of these taxes.

Likewise, the threshold for trusts and estates will be different than that for individuals; it will be based on the level of taxable income that puts the entity into the highest tax bracket – so the threshold will be significantly lower than that for individuals. Yearly increases for inflation in tax brackets make it difficult to estimate the amount of taxable income that may subject a trust or estate to the new tax. However, to give you an idea of what this threshold may be, in 2012, $11,650 of income would put a trust or estate account into the highest tax bracket for the entity. Above that level (as indexed for inflation up to 2013), the entity would be subject to the additional 3.8% tax on investment income.

What you should do now

In preparation for the additional Medicare tax, begin considering how the investment income you anticipate receiving in 2013 could affect your tax situation. As you, your Financial Advisor and tax advisor evaluate some of the strategies below, keep in mind that a decision to implement one or more of these ideas should not be based on tax planning alone. You will want to consider your investment time horizon, risk tolerance and asset allocation as you weigh each of these strategies. Implementing one or more could have additional financial implications or affect your estate and wealth transfer plans.

Here are four strategies that may minimize your exposure to the 3.8% Medicare tax:

Consider tax-exempt bonds. As noted, tax-exempt interest is excluded from both your MAGI and net investment income calculations. Such income will not push your MAGI over the threshold and make you subject to these taxes. However, you'll have to weigh this advantage against the effect on your overall asset allocation. Tax-exempt investments have inherent risks, including:

- Market risk – your bond investments' principal value will fall if interest rates rise.
- Inflation risk – bonds typically do not protect against the rising cost of living.
- Tax – certain municipal bonds may expose you to the AMT or state income tax.

Roth conversions. Converting some or all of a traditional IRA or qualified retirement plan to a Roth IRA may reduce your exposure to these new taxes in the future. Tax-free distributions from a Roth IRA are not considered investment income and will not increase your MAGI. Although traditional IRA or qualified plan withdrawals are not considered investment income, such withdrawals increase your MAGI – perhaps subjecting you to these new taxes (as shown in the example on page 4).

If you're considering a Roth conversion, you'll also want to control the timing of such a conversion. Converting to a Roth creates taxable income, and doing so in 2013 or after could boost your MAGI to a level that triggers or increases these new taxes. Keep in mind you can convert portions of your traditional IRA or qualified plan over time, thus controlling the taxable income you recognize in any one year and perhaps helping you to reduce or avoid these new taxes.

You can count on us

You'll want to involve your tax and legal advisors and your Financial Advisor to help you evaluate your financial, investment and tax situation. Together, you may be able to implement a number of strategies to help you reduce or avoid these new taxes.

Take advantage of tax-deferred vehicles. You may want to take a second look at your contribution levels to your employer retirement plan or annuities. Income received from tax-deferred investments is not included in the calculation for these taxes until it is distributed. In addition, these vehicles' tax-deferral feature gives you the potential to accumulate more for your retirement.

Time your income recognition. To the extent possible, pay particular attention to when you will receive income, generate capital gains, exercise stock options or take taxable distributions from IRAs or retirement plans.

- Consider triggering some income before 2013 by, for example, realizing capital gains or exercising stock option grants.
- After 2012, try to avoid spikes in income that could push your MAGI over the threshold. If you anticipate receiving a sizable payout from your employer after 2012, it may be beneficial to spread the receipt of this payment over multiple years to reduce each year's addition to your MAGI. When considering this strategy, you will need to look at both your employer's flexibility in allowing multi-year payments as well as your employer's financial ability to continue making those payments.