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TAX AND BUSINESS Alert™

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New 3.8% Medicare Contribution Tax on Unearned Income

Beginning in 2013, the 2010 Health Care Act, as amended by the 2010 Health Care Reconciliation Act, imposes a Medicare contribution tax on unearned income (Medicare contribution tax) on individuals, estates, and trusts. The tax is generally levied on income from interest, dividends, annuities, royalties, rents, and capital gains, but can also be levied on home sale gains in excess of the applicable exclusion amount.

For individuals, the tax is 3.8% of the lesser of (a) *net investment income* or (b) the excess of *modified adjusted gross income* (MAGI) over the applicable threshold amount. Net investment income is investment income reduced by the deductions properly allocable to such income. Fortunately, qualified retirement plan distributions are not included in investment income. MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to the foreign earned income. The threshold amount for those subject to the tax is $250,000 for joint returns or surviving spouses, $125,000 for separate returns, and $200,000 in other cases.

Where possible, taxpayers can reduce their 2013 MAGI by receiving 2012 bonus, profit sharing, or other incentive payments in 2012 versus 2013. But recognize that doing so will accelerate into 2012 the regular income tax due on these payments. If 2013 MAGI is under the applicable threshold amount, there will be no Medicare contribution tax liability.


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Example: Single taxpayer's MAGI exceeds the $200,000 threshold.

Carol, a single taxpayer, has net investment income of $100,000 and MAGI of $220,000 in 2013. She would pay a Medicare contribution tax on $20,000, the amount by which her MAGI exceeds the $200,000 threshold since this is less than her net investment income of $100,000. Carol's 2013 Medicare contribution tax would be $760 ($20,000 × 3.8%). *(Continued on Page 2.)*

Additional 0.9% Medicare Surtax in 2013

The Patient Protection and Affordable Care Act provides that, beginning in 2013, a new 0.9% Medicare surtax will be imposed on wages and self-employment (SE) income in excess of specific MAGI threshold amounts: $250,000 for joint filers; $125,000 for married filers; and $200,000 for all other taxpayers. The employer portion of the Medicare tax is not increased in 2013.


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Observation: Employees generally pay Medicare taxes at a 1.45% rate on all wages. This new provision will increase the rate to 2.35% in 2013 on wages exceeding the applicable threshold amounts.

Some taxpayers can eliminate or minimize this new surtax by implementing strategies to reduce SE income. These include, among others, leasing real property to the taxpayer's closely held business, renting business property to a proprietor spouse, employing family members in the business, and, in certain situations, adopting a self-insured medical reimbursement plan.

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However, if a taxpayer's 2013 MAGI exceeds the threshold amount by at least the amount of the net investment income, the taxpayer will pay 3.8% on the full amount of his or her net investment income.

Example: Taxpayer's MAGI exceeds the threshold by more than net investment income.

Wesley, a single taxpayer, has 2013 net investment income of $110,000 and MAGI of $400,000. Because his MAGI exceeds the $200,000 threshold amount by more than his net investment income, he would pay a Medicare contribution tax on his full $110,000 net investment income. Wesley's 2013 Medicare contribution tax would be $4,180 ($110,000 × 3.8%).

A large home sale gain *could* be subjected to the Medicare contribution tax. However, any amount realized from the sale of a principal residence excluded from federal taxation (up to $250,000; $500,000 for certain married couples filing a joint return) is not subject to the Medicare contribution tax.

Example: Home sale gain in excess of the $500,000 exclusion.

The Clarks, a married couple, have 2013 AGI of $260,000. They sell their principal residence for $1.2 million, and realize a net gain of $700,000. Their 2013 MAGI is $460,000 ($260,000 AGI + $200,000 home sale gain in excess of $500,000). Because their MAGI exceeds the $250,000 threshold for joint filers, they would pay a Medicare contribution tax on $200,000 from the sale of their home. [The Medicare contribution tax is computed on the lesser of the $200,000 applicable home sale gain or $210,000 ($460,000 MAGI – the $250,000 threshold).] Their 2013 Medicare contrilobution tax would be $7,600 ($200,000 × 3.8%).

Planning Tip: If a taxpayer anticipates receiving large capital gains from the sale of a business, investments, a principal residence, real estate, etc., these transactions should be completed before 2013, if possible, to avoid the Medicare contribution tax in 2013.

Finally, the Medicare contribution tax is paid in addition to the 0.9% Medicare surtax on wages and self-employment income in excess of the applicable threshold amounts (see above). Taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes in 2013.

Cash Management Strategies for a Secure Retirement

For those of us looking forward to achieving a financially secure retirement, an overriding question is "how much will I need to live comfortably during retirement?" Unfortunately, there is no one-size-fits-all answer; everyone has different goals and objectives. However, we have listed below some ideas to help build that retirement nest egg.

Budgeting. Develop a budget that minimizes nonessential current expenditures in the interest of saving for the desired standard of living during retirement. Developing a budget is also a good first step in accumulating some cash for emergencies.

Building a Cash Reserve. Develop and maintain a cash reserve to meet emergency needs. Building an adequate reserve can help avoid having to liquidate investments when the market is depressed or it is otherwise inadvisable to sell.

Forced Savings. Some people are less likely to spend money if they do not actually see the funds, and some need the discipline of having savings taken care of automatically. These individuals may find it easier to set funds aside if they arrange to have their bank automatically and systematically transfer funds from checking to savings or investment accounts. Also, they may have their employer take automatic payroll deductions to fund voluntary contributions to retirement [e.g., 401(k)], savings, or stock plans.

Allocating Less to Other Parts of Financial Plan. Consider allocating a lesser amount of funds to other parts of your financial plan. For example, education costs for children or grandchildren may need to be revised and less expensive institutions considered. Gifts to family members and preretirement travel and entertainment may need to be reduced.

Minimizing, Restructuring, or Eliminating Debt. Generally, debt should be minimized as retirement approaches. If borrowing is necessary, home equity loans or borrowing from a qualified retirement plan (if permitted) should be considered. Home equity loans are generally a relatively cheap source of financing (considering the after-tax borrowing rate), and the repayment terms often are more generous than those of unsecured loans. The interest on a home equity loan up to $100,000 is generally tax deductible on your federal return, regardless of how the loan proceeds are used. Loans from qualified plans generally carry relatively low interest rates, and the interest paid on the loan is an addition to your account balance.

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Using a Reverse Mortgage. A *reverse mortgage* is a loan in the form of monthly payments or a lump-sum payment against the equity in your personal residence. If age 62 or above, you might consider a reverse mortgage for one or more of the following reasons: (a) paying off personal debts, (b) paying for medical care, (c) covering financial emergencies, (d) delaying withdrawals from a retirement plan, or (e) supplementing monthly income. The loan is not repaid until the homeowner permanently moves from the residence, the property is refinanced or sold, or the homeowner dies.

Delaying Retirement. Working for a longer period can make a significant difference in your retirement picture. For example, in addition to continuing earnings, working longer may provide continued fringe benefits and contributions to retirement plans. Extending the working period could also delay IRA or other retirement account withdrawals needed to cover living expenses, thus allowing them to grow longer on a tax-deferred basis. Delaying social security benefits can also result in a higher monthly benefit amount.

Asset Protection Characteristics of LLCs

Limited liability companies (LLCs) offer the personal financial protection equivalent to that provided by corporations. This means that members of an LLC generally are not liable for its debts or liabilities. (By way of comparison, in a limited partnership, at least one partner must be a general partner who is liable without limitation for debts of the partnership.) But if the LLC fails to file articles of organization, state law may provide that the conduct of business activity causes the persons acting through the LLC (the LLC members) to lose their liability protection.

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Caution: An LLC cannot be used to protect a member's personal assets from that member's illegal acts. Similarly, a professional LLC cannot shield its members from liability for errors, omissions, or misconduct related to the provision of professional services.

While the law on piercing LLCs to reach the personal assets of their owners is still developing, most commentators expect that the tests applied by the courts will be similar to those used in cases involving corporations. As with a corporate shareholder or limited partner, the LLC member's liability to the LLC itself is generally limited to any required but unpaid capital contributions.

Although state law generally shields LLC members from liability for the LLC's debts, there are situations where members will have personal liability. Under most states' laws, when a partnership is converted to an LLC, the general partners remain jointly and severally liable for the outstanding debts of the partnership on the date of conversion. Furthermore, the LLC members may be liable for sales tax and other state taxes despite the limitations on their liability under the state's LLC law.

In addition to liability protection, LLCs have an important asset protection advantage over corporations. A member's creditors generally cannot gain full ownership of the member's LLC interest. Instead, a creditor may be able to obtain a charging order, which conveys the right to receive distributions. But other ownership attributes, such as the right to vote or sell the LLC interest to satisfy the creditor's claims, normally are not available to the creditor. In contrast, creditors of a corporate shareholder can obtain full ownership of the stock, generally without any restrictions on the ability to vote or sell the stock.

Please contact us to discuss the liability and asset protection characteristics of LLCs or any other tax compliance or planning issue.