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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

July 2013

The Marriage Penalty

The *marriage penalty* occurs under the current tax system when a married couple pays more federal income tax when filing jointly than they would if they had remained single and each filed as an individual taxpayer. Historically, Congress has taken steps and passed legislation to provide relief from the marriage penalty. However, the 2010 Affordable Care Act (Affordable Care Act) and the American Taxpayer Relief Act of 2012 (2012 Taxpayer Relief Act) increased the marriage penalty for some high-income couples. Let's take a look at how this legislation adversely impacts married taxpayers.

The Affordable Care Act brought about the 3.8% net investment income tax (3.8% NIIT) and additional 0.9% Medicare tax. These taxes are sometimes referred to as "Medicare Taxes."

The 3.8% NIIT is generally assessed on investment income (interest, dividends, annuities, royalties, rents, and capital gains). The tax is 3.8% of the lesser of net investment income or modified adjusted gross income (MAGI) over an applicable threshold. The thresholds are $250,000 for a married couple filing jointly and $200,000 for a single filer. So a married couple with MAGI of $400,000, all of which is investment income would pay a surtax of 3.8% on $150,000 ($400,000 – $250,000) or $5,700. If that couple was not married, filed as single taxpayers, and each had $200,000 of income subject to the 3.8% NIIT, they would each have an exclusion of $200,000 available and, therefore, neither would owe this surtax.

The additional 0.9% Medicare tax is assessed on employment and self-employment earnings above the same thresholds. Therefore, a married couple with joint employment earnings of $400,000 would pay the additional 0.9% Medicare tax on $150,000 ($400,000 – $250,000) or $1,350. Once again, if the individuals were not married, each had $200,000 in earnings, and filed as single taxpayers, they each would have the $200,000 exclusion available and neither would owe the tax.

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When added to the 3.8% NIIT, that's a $7,050 ($5,700 + $1,350) marriage penalty resulting from the Affordable Care Act.

The 2012 Taxpayer Relief Act added new 39.6% ordinary income and 20% capital gains rates for some high-income taxpayers. Once again, these new rates potentially increase the marriage penalty. Both rates apply to married couples filing jointly with taxable income above $450,000 and single taxpayers with taxable income above $400,000.

Married individuals with taxable income of $800,000 filing jointly, will pay 39.6% on $350,000 (800,000 – $450,000) of that income. In contrast, if the couple were not married, had $400,000 of taxable income each, and filed as two single taxpayers, their marginal tax rate (rate on the last dollar of income) would be 35%. So, they would not pay 39.6% on any of their

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Tax Calendar

July 15—If the monthly deposit rule applies, employers must deposit the tax for payments in June for social security, Medicare, withheld income tax, and nonpayroll withholding.

July 31—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through June exceeds $500.

—The second quarter Form 941 (Employer's Quarterly Federal Tax Return) is also due today. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until August 12 to file the return.

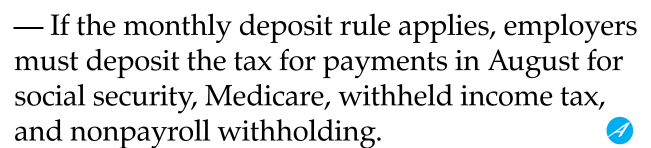
August 15— If the monthly deposit rule applies, employers must deposit the tax for payments in July for social security, Medicare, withheld income tax, and nonpayroll withholding.

September 16—Third quarter estimated tax payments are due for individuals, trusts, and calendar-year corporations.

—If a five-month extension was obtained, partnerships should file their 2012 Form 1065 by this date.

—If a six-month extension was obtained, calendar-year corporations should file their 2012 income tax returns by this date.

— If the monthly deposit rule applies, employers must deposit the tax for payments in August for social security, Medicare, withheld income tax, and nonpayroll withholding.



New In-plan Roth Rollover Provision

A provision in the recently enacted American Taxpayer Relief Act of 2012 permits an individual to transfer any portion of their balance in an employer-sponsored tax- deferred retirement plan account into a Roth IRA account under that plan. This transfer option for retirement plans is only available if the employer plan includes this feature (i.e., in-plan Roth) in the plan. Prior to the Act, only eligible retirement plan distributions could be rolled over to an in-plan Roth IRA.

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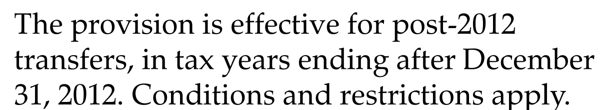
The catch under the new Roth transfer provision is that the transfer will be fully taxed, assuming the conversion is being made with pretax dollars (money that wasn't taxed to an employee when contributed to the qualified employer-sponsored retirement plan). The taxable amount will also include any earnings on those pretax dollars.

The provision is effective for post-2012 transfers, in tax years ending after December 31, 2012. Conditions and restrictions apply.



The Marriage Penalty

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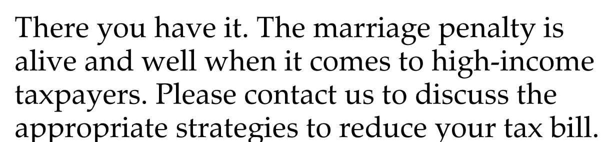
income, but would top out in the 35% bracket. This would make quite a difference in their overall tax bill. In a similar fashion, a married couple filing jointly with $800,000 in long-term capital gains would have $350,000 ($800,000 – $450,000) subject to the new 20% capital gains rate. Once again, if they were not married with $400,000 each in long-term capital gains and filed as two single taxpayers, the maximum rate on their gains would be 15%.

There you have it. The marriage penalty is alive and well when it comes to high-income taxpayers. Please contact us to discuss the appropriate strategies to reduce your tax bill.



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Tax Impact of Investment Strategies

Higher 2013 income and capital gains rates and the new 3.8% net investment income tax (3.8% NIIT) may cause high-income investors to reexamine their investment strategy. The type of account, taxable or tax deferred (e.g., qualified retirement plan), could affect the investment strategy in a number of ways. Qualified retirement plans, because of their tax-deferred nature, tend to favor the following strategies:

1. More frequent turnover (securities transactions within the portfolio) can be tolerated. Recognition of gains is not an issue in a qualified plan account; therefore, a strategy that allows frequent buying and selling (turnover) of the underlying investments would not have a detrimental effect because of associated tax liabilities.

2. More active management might be appropriate for a qualified plan, whereas passive investments such as index funds, might be held in taxable accounts.

3. Large-cap investments, which are more likely to be dividend-paying companies, may be better suited for qualified plan accounts because the income is not currently taxed.

4. Portfolio rebalancing (e.g., shifting funds from small cap to large cap stocks) is better accomplished using assets in a qualified plan to minimize the recognition of taxable income.

Taxable accounts tend to favor the following strategies:

1. Buy-and-hold strategies are appropriate to limit gain recognition and to limit gains to assets that qualify for preferential long-term gain treatment.

2. Passive investments, particularly index funds that have minimal taxable distributions, are more appropriate for taxable accounts.

3. International funds, which frequently have associated foreign tax payments, are more appropriate for taxable accounts so the foreign tax credit can be claimed.

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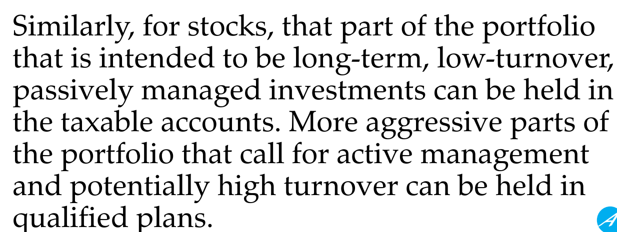
4. Small-cap growth stocks are more appropriate because of the minimal dividend income generally associated with these types of investments.

A topic of continuing discussion among investment professionals is where to hold fixed-income investments and where to hold equity investments. Generally, sufficient fixed-income investments need to be in taxable accounts to provide liquidity. Those investments could be, for example, either tax-free or taxable bonds, depending on the after-tax yield as determined by your marginal tax rate. The need for current income will also affect whether additional fixed-income investments are held outside of qualified plans. Beyond the liquidity amount and provision for current income, the remainder of the fixed-income portfolio can be held in a qualified plan.



Similarly, for stocks, that part of the portfolio that is intended to be long-term, low-turnover, passively managed investments can be held in the taxable accounts. More aggressive parts of the portfolio that call for active management and potentially high turnover can be held in qualified plans.

Residential Energy Credit

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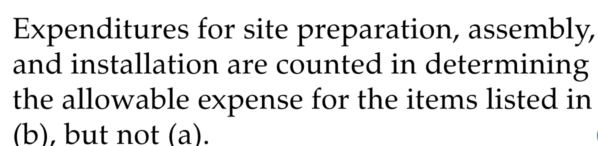
including heat pumps, water heaters, and central air conditioners) paid during the tax year.



Expenditures for site preparation, assembly, and installation are counted in determining the allowable expense for the items listed in (b), but not (a).

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Residential Energy Credit

One way to control the cost of home energy use is to make your home more energy efficient. Better still when those energy-saving improvements qualify for a federal tax credit. Fortunately, individual taxpayers are allowed a personal tax credit for energy-efficient improvements to their principal residence. The Nonbusiness Energy Property Credit (Residential Energy Credit) has been available since 2006 and was recently extended through 2013.

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The Residential Energy Credit equals 10% of certain qualified expenditures plus 100% of certain other qualified expenditures, subject to a maximum overall credit of $500. That's pretty modest, and the $500 cap must be reduced by any credit claimed in an earlier post-2005 year. This restriction will cause some taxpayers to be ineligible for 2013. Still, for those who are eligible, $500 is a lot better than nothing.

The good news is the credit, when allowed, covers a broad range of energy-saving expenditures for a taxpayer's principal U.S. residence (including a manufactured home). Plus, it's available against alternative minimum tax (AMT) and there are no income restrictions. However, expenditures for vacation homes and foreign residences are ineligible.

The Residential Energy Credit equals the sum of (a) 10% of the amount paid for qualified energy-efficient improvements (i.e., building envelope components meeting certain requirements) installed during the tax year (no more than $200 of which could be for new windows), and (b) the amount of any residential energy property expenditures (i.e., $50 for each advanced main air circulating fan; $150 for each qualified natural gas, propane, or oil furnace or hot water boiler; and $300 for qualified energy-efficient property,

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