Planning for the New Medicare Taxes

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Over three years have passed since sweeping health insurance legislation was signed into law. Nearly all individuals will soon be required to obtain health insurance or else face a penalty. Business owners will be deciding if it is more beneficial to keep group health policies for their employees or pay penalties themselves.

State insurance exchanges are being developed to help consumers find the most affordable policies. To help manage the costs of these expanded programs, new taxes were introduced and have become effective this year. So what are the taxes, will you be affected, and what planning can be done to minimize the impact?

To start, you may be affected by the new Medicare taxes if a figure from your tax return called the modified adjusted gross income is above one of these three thresholds: $250,000 for joint returns and surviving spouses, $125,000 for married filing separately and $200,000 for everyone else (e.g. single). Note these thresholds are not indexed for inflation.

The first way these taxes are applied is through your earned income. If you're an employee, you may be used to seeing a 1.45 percent "hospital" tax withheld from your paycheck. For the income above the applicable threshold, you'll pay an additional 0.9 percent for a total of 2.35 percent. Self-employed individuals pay the additional 0.9 percent as well.

If you're single and expecting to earn more than $200,000, this tax should automatically be withheld from your paycheck. However, this tax applies to joint income as well. If you expect to cross the $250,000 threshold with a spouse, you may need to adjust your withholdings or quarterly estimated payments accordingly to avoid penalties. Aside from that, there's not much you can do from a planning standpoint unless you choose to earn less income. That's probably not one of our recommended strategies!

The other way you may see these taxes affect you is through your unearned income. We also call this your net investment income. This includes gross income from interest, dividends, capital gains, annuities, royalties and rent. These amounts are reduced by any allowed, deductible investment expenses. If an income source is already exempt from tax, such as municipal bond interest, it would not be included. Fortunately, distributions from retirement accounts would not be included either, unless the distribution is from a non-qualified annuity.

We now have a 3.8 percent "surtax" on this net investment income. The tax is applied on the lesser of net investment income or excess income over the applicable threshold. A couple of examples may help. If you were filing single with a $230,000 income, of which $40,000 was net investment income, you would have $30,000 subject to the surtax. This is the excess income over the $200,000 threshold, and this excess is less than your actual net investment income. The actual surtax in this case would be $1,140.

Now if you were single with a $350,000 income, of which $20,000 was net investment income, you would have $20,000 subject to the surtax. This is simply the net investment income because it is less than the excess income over the threshold ($150,000). The actual surtax in this case would be $760.

To clarify, this surtax is in *addition* to the investment taxes you normally pay. For example, if your tax rate for long-term capital gains was previously 15 percent, your new effective rate would now be as high as 18.8 percent. Now that we have some understanding of the tax exposure, what are some of the planning strategies we can employ to mitigate the effects of this new surtax? Here are a few strategies we consider:

- Identify ways to reduce your net investment income. One example is considering municipal bonds over taxable bonds. The taxable equivalent yield for municipals is now slightly more favorable with these tax law changes.
- Maximize all allowable deductions against your investment income.
- Accelerate or defer income into years so that you stay below the applicable thresholds mentioned earlier. An example of accelerating income is taking larger capital gains in lower income years. One might have an option to defer income, such as a year-end bonus, through a deferred compensation plan.
- Shift more investments into tax preferred accounts such as IRAs and 529 College Savings plans.
- Consider Roth IRA conversions. If future required distributions from traditional IRAs project to push you over the threshold, Roth conversions may be appropriate. They may also make sense if done in a year where the resulting taxable income from the conversion doesn't push you over the threshold.

The new Medicare taxes add yet another layer of complexity to the tax planning we do for clients. The planning may differ if we're simply trying to reduce the tax consequences from one large tax year compared to helping those with ongoing exposure to these new taxes. In the end, it's important to remember that our tax strategies are there to complement our investment strategies and not dictate them.