# A New Federal Surtax on Investment Income: Some Planning May Be In Order

*By Sumner B. Tilton, Jr., Esq.*

When the United States Supreme Court affirmed the constitutionality of President Obama's healthcare plan in June, many taxpayers having adjusted gross income in excess of $200,000 (single) or $250,000 (married, filing jointly) cringed. They cringed because the 2012 law that created Obamacare includes a 3.8% additional tax on investment income that goes into effect on January 1, 2013.

The new surtax computation is not simple. First, it involves the calculation of a taxpayer's "modified adjusted gross income (MAGI)" which, generally speaking, is all income from interest, dividends, wages, long and short term capital gains, rents and pass-through income from partnerships and trusts. It is not reduced by any deductions on page 2 of Form 1040. Second, it involves the calculation of the taxpayer's "net investment income." Investment income for most taxpayers is comprised of dividends, rents, interest (except municipal bond interest), short- and long-term capital gains, taxable annuity payments, income from the sale of taxpayer's residence above the $250,000/$500,000 exemption, gain on the sale of a vacation home, and passive income from pass-through investments in limited partnerships, S-corporations, LLCs and the like. Investment income does not include payments from a 401(k) plan, an IRA, qualified pension plan benefits or Social Security benefits.

The new 3.8% tax is assessed on the lesser of (1) net investment income, and (2) the excess of MAGI above the $200,000/$250,000 MAGI threshold. For instance, a married couple with wages of $50,000 and net investment income of $175,000 would not be liable for the surtax because the couple has not exceeded $250,000 of modified adjusted gross income, but a married couple with wages of $100,000 and investment income of $175,000 would owe a tax of 3.8% of $25,000 ($950.00) because they exceeded the modified adjusted gross income threshold.

Both of the couples cited above could receive an additional $25,000 from Social Security, 401(k) plans or IRAs during the year. The first couple would not owe any surtax on these amounts as their MAGI would still be under the threshold, but the second couple would owe another 3.8% tax on the additional $25,000 of income. Even though this income would be exempted from the definition of net investment income, it would increase their MAGI in a way that would make another $25,000 of their investment income subject to the tax.

With January 1, 2013, fast approaching, high income taxpayers may want to push all discretionary investment income into 2012. That would save them 3.8% if their adjusted gross income exceeds $200,000/$250,000 and would save them 8.8% on capital gains if the Bush-era tax cuts are allowed to expire on January 1st. Examples include taxpayers that are contemplating the sale of their businesses and taxpayers planning to sell their homes. Obviously, installment sales on the sale of businesses should be avoided.

If the Bush-era tax cuts are allowed to expire, the tax on dividend income will revert to a taxpayer's marginal rate on January 1st (for most investors, they currently are taxed at 15%). Again, taxpayers with significant dividend income may want to sell some portion of their equities (especially those with large unrealized gains) in 2012 and reinvest the proceeds in municipal bonds. This could result in quadruple benefits, i.e., (a) ensure a lower capital gains tax on the sale, (b) avoid dividend income in 2013 that would be subject to the new surtax, (c) reduce 2013 adjusted gross income as municipal bond interest is not included and (d) avoid any regular or additional investment tax on municipal bond interest (which is exempt from both).

Tax planning is complex and time consuming. It is best to engage advisors that are familiar with the trade-offs and benefits and start early enough to put your plans into effect before January 1, 2013.


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