



How the 3.8 Percent Medicare Surtax Can Bite Your Clients

► For certain clients, this tax relating to the Affordable Care Act may result in an unpleasant surprise.

By Patti S. Spencer

An important service that advisors can offer this year is helping clients understand the Affordable Care Act's unearned income Medicare contribution, a 3.8 percent surtax that became effective Jan. 1 on investment income for individuals, trusts and estates.

It is referred to as the "3.8 percent surtax," the "3.8 percent investment tax" and the "3.8 percent Medicare tax." This 3.8 percent surtax is found in Section 1411 of the Internal Revenue Code. In an

effort to "help" taxpayers understand the new tax, the Internal Revenue Service (IRS) issued final regulations for Section 1411 on Nov. 27, 2013. This "help" is 400 pages long, due to "what ifs," exemptions and exemptions to exemptions!

For individuals, the calculation of the 3.8 percent Medicare surtax is dependent on two numbers: the taxpayer's net investment income (NII) and the taxpayer's modified adjusted gross income (MAGI). For each taxable year, the MAGI, after being reduced by a fixed threshold, is compared to the NII. The 3.8 percent Medicare surtax is applied on the lower of the two numbers. This means that for individuals who have little or no net investment income, their 3.8 percent Medicare surtax will be min-

imal if not zero. The three thresholds mentioned above are:

- » \$250,000 for married couples filing jointly.
- » \$125,000 for married couples filing separately.
- » \$200,000 for everyone else.

Here is an example. Mary Smith, who is single, earned \$150,000 in salary for 2013. In addition, Mary earned \$75,000 of net investment income. Mary's modified adjusted gross income would be \$225,000, which is the sum of her salary and her net investment income. Her threshold is \$200,000. Mary's MAGI, af-

ter being reduced by a fixed threshold, is \$25,000 (\$225,000 minus \$200,000). When compared to her \$75,000 of NIL, the 3.8 percent Medicare surtax is applied to the \$25,000 because it is the lower of the two numbers. On Mary's Form 1040 for 2013, she will owe additional taxes of \$25,000 x 3.8 percent, or \$950. For Mary, the effect of the new surtax is \$950 in additional tax.

Estates and trusts get hit harder. The calculation of the 3.8 percent Medicare surtax is also dependent on two numbers: an estate's or trust's undistributed net investment income (UNII) and the estate's or trust's adjusted gross income (AGI). Similar to the calculation for individuals, the AGI for the taxable year is first reduced by a fixed threshold amount and then compared to the UNII. The lower of the two is multiplied by 3.8 percent to determine the Medicare surtax for that taxable year. However, the threshold is adjusted each year based on the first dollar amount in the highest tax bracket. For fiscal year 2013, that amount is only \$11,950. Compare

this to \$250,000 for a married couple filing jointly.

In order to determine whether the surtax applies, it is important to understand what qualifies as net investment income. **Net investment income includes the following items, reduced by any deductions allocable to such income:**

- » Interest, dividends, royalties, annuities, rents.
- » Income derived from passive activities.
- » Income from trading financial instruments and commodities.
- » Net capital gains derived from the disposition of property (other than property held in an active trade or business).

Net investment income does not include:

- » Active trade or business income.

- » Gain on sale of an active interest in a partnership or an S corporation.
- » Distributions from IRAs or qualified retirement plans.
- » Income from tax-exempt municipal bonds.
- » Tax deferred nonqualified annuities.
- » Income taken into account for self-employment tax purposes.
- » Capital gain excluded on the disposition of a personal residence.

Take note that even with the present "Obamacare" discussions, debates and delays, this surtax still stands. [in](#)

Trusts, estates and tax attorney **Patti S. Spencer** is a nationally recognized author and educator. She is founder and owner of The Spencer Law Firm, Lancaster, Pa. Patti may be contacted at patti.spencer@innfeedback.com.



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