Fast Fact

Two new health care taxes: Who they impact and what you can do

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Higher taxes for higher income taxpayers

Legislation connected with the Affordable Care Act added new provisions to the Internal Revenue Code that will impose two new taxes beginning in 2013. These taxes will impact many high income individuals, as well as certain estates and trusts.

Medicare Hospital Insurance Payroll Surtax[1]: This new tax is an additional 0.9% Medicare payroll surtax on wages above $200,000 for individuals and $250,000 for married couples filing jointly.

Net Investment Income Tax:[2] The new law adds a 3.8% tax on certain types of unearned income, including interest, dividends, capital gains and other investment income.

A higher Medicare payroll tax on earned income

Earned income is subject to the Medicare payroll tax of 2.9%, with workers and employers each paying 1.45% and self-employed paying both halves. Under the new tax provision, high income earners will owe an additional 0.9% on wages, compensation and self-employment income that exceed the applicable thresholds based on their tax filing status. For married couples filing jointly, the threshold is $250,000; for married couples filing separately, the threshold is $125,000; for all others, the threshold is $200,000. Since these thresholds are not indexed for inflation, it seems likely that more people will be subject to the higher tax in the future.

Example: A married couple filing jointly has a modified adjusted gross income (MAGI) of $300,000 and combined wage income of $280,000. The amount of wage income above $250,000 is subject to the 0.9% surtax — so the couple pays $270 ($30,000 X 0.9%) in taxes in addition to the standard 1.45% Medicare payroll tax. For that $30,000, the effective employee-portion of Medicare payroll tax is 2.35%.

Keep in mind that employers are required to withhold the Additional Medicare Tax on wages paid to employees that exceed $200,000, regardless of an employee's filing status. For married taxpayers or employees with multiple jobs, this could result in either over withholding or under withholding, which will be taken into account on their federal income tax return.

A new tax on unearned income

Beginning in 2013, a 3.8% tax on net investment income could apply if MAGI exceeds the applicable threshold. For individuals, the tax applies as outlined in the following exhibit:

EXHIBIT 1: For individuals, the new 3.8% tax applies to the lesser of:

Modified adjusted gross income that exceeds	or	"Net investment income"
$200,000 for singles; $250,000 for married taxpayers filing jointly; $125,000 for married taxpayers filing separately		Which is investment income (as defined below) reduced by those deductions properly allocable to the investment income.

MAGI that exceeds the threshold triggers a two-part calculation. First, how much is above the threshold and second, how much total net investment income. The surtax applies to the lesser of the two. For example, if a single tax filer has $250K in MAGI in 2013, then she is $50K over the threshold. Assuming her net investment income is $10K, then that is lower than $50K — so she is subject to a surtax of $380 ($10k X 3.8%). This surtax is on top of any other applicable taxes such as ordinary income or under the alternative minimum tax.

[1] Source: "IRS-Questions and Answers for the Additional Medicare Tax"
[2] Source: "IRS-Net Investment Income Tax FAQs"
[3] For more details, taxpayers who may be impacted should work with a qualified tax advisor.

EXHIBIT 2: Net investment income[3]

Net Investment income includes income from:	But does not include:
Interest Dividends Non-qualified Annuities Royalties Rents Gain from the sale/disposition of certain property (capital gains) Substitute dividend/interest payments (e.g. payments in lieu of dividends) A trade or business that is considered a passive activity (under the passive loss rules) or is in the business of trading in financial instruments or commodities/related derivatives.	Wages, unemployment compensation, Social Security benefits Self-employment income that is taken into account for Self-Employment Contributions Act (SECA) tax purposes Qualified retirement plan distributions IRAs, 401(k)s, pensions, etc. Non-qualified deferred compensation (NQDC) distributions Tax-exempt income Municipal bond interest Excluded gain on the sale of a principal residence Life insurance death benefits, etc. Trade or business income other than income from a trade or business described in the final bullet on the left. However, income from the investment of working capital does not fall within this exception.

What steps can I take?

To lessen the effect of these taxes, investors might consider taking steps to reduce the likelihood of crossing the applicable MAGI threshold level, limit the amount by which one exceeds a threshold, or lower net investment income for certain years.

Investors can potentially lower MAGI and/or net investment income by deferring wage income and contributing to investment accounts that grow on a tax deferred basis. Ways to do this in the workplace include:

> Enrolling in a non-qualified deferred compensation plan (NQDC), if eligible

> Contributing up to the maximum pretax amount to a workplace plan

> If you have self-employment or contractor income (e.g. Form 1099 income), you may be eligible to contribute all or a portion of the 1099 amount to a Simplified Employee Pension IRA or to a Solo K plan that you set up on your behalf.

These steps can potentially lower MAGI in the current tax year as well as permit tax deferred growth. When distributed in the future, the taxable amounts will contribute to MAGI in the year of distribution, but will not be included as net investment income under the 3.8% tax.

There are two other steps you can take to place more dollars in a tax deferred account. Although these both involve making after-tax contributions that will not reduce your current MAGI, they do enable you to have a greater amount of assets in a tax deferred vehicle. This means any growth while in the account will not affect MAGI, and any future distribution will not be included as net investment income:

> **After-tax 401(k) contributions:** Your 401(k) plan may have an after-tax feature. In that case, even if you have maximized your salary deferral amount to either or both a pretax or designated Roth account in the 401(k) plan, you may be able to contribute more of your wages to help you get closer to or to reach the 401(k) plan 415 limit, which is $51K or $56.5K (catch up) for 2013.

> **Non-deductible IRA contributions:** You and your spouse can contribute to a traditional IRA even if you are not eligible to make a deductible contribution and even if your spouse does not have earned income.

Find tax efficient ways to acquire Roth assets

High income earners may not be able to contribute to a Roth IRA, but there are two potential strategies for acquiring Roth assets even if this is the case.

Roth Conversion: There are no income limits on Roth conversions. For accounts that could have a high percentage of after-tax compared to pretax dollars (such as an after-tax account in your workplace plan), a Roth conversion may make sense.The converted pretax dollars are included as ordinary income in the year of conversion, increasing MAGI for that year, but will not count as net investment income under the 3.8% tax. The converted after-tax dollars are not subject to taxation.

Designated Roth accounts in a workplace plan are another consideration since there are no income limits on Roth contributions in a defined contribution plan.

Remember that contributions to a designated Roth account in your defined contribution plan will not lower your MAGI. An important benefit of acquiring Roth assets is that qualified distributions are tax free and therefore do not count under either MAGI or net investment income.

Asset allocation and asset location

In the current low growth, low return and higher tax environment, maximizing after-tax return is a critical objective. A strategy that combines asset allocation and asset location can be a contributing factor to improving after-tax returns.

Asset allocation: Investors with fixed income investments in taxable accounts who are concerned about improving after-tax return should re-look at their allocation to tax exempt securities. Municipal interest and municipal bond fund dividends are neither included under MAGI nor under net investment income (Note: capital gains from the sale of municipal securities are subject to both).

Investors in the highest tax bracket and who could be subject to the tax on net investment income may find that tax equivalent yields are more generous under the new tax environment than in the 2012 tax year.

Asset location is an important consideration for investors whose holdings include taxable fixed income investments. Through consolidation of retirement assets, investors may be able to locate the most highly taxed fixed income investments — those subject to both ordinary income rates and potentially to the net investment income tax into tax deferred vehicles. Floating rate, mortgage backed, global bond, real estate investment trusts, and high yield taxable fixed income securities and mutual funds are all candidates for asset location. For investors who are still working and are not looking for a current paycheck, shifting these income-producing assets from taxable to tax-deferred accounts could mean significantly better after-tax returns. And in the future when the income is distributed, the taxable portion will be included as ordinary income (perhaps in a lower tax bracket) and will not count as net investment income, unless held in a nonqualified annuity. Of course, tax considerations are only one aspect of a financial plan. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance.

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