

Medicare investment earnings surtax

What you should know

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This paper will examine the practical tests and specific elements of the Medicare Investment Earnings surtax (I.R.C. Sec. 1411), look at some examples of how the tax is calculated and go over some strategies investors may want to consider to minimize and/or avoid this tax.

When did the tax start?

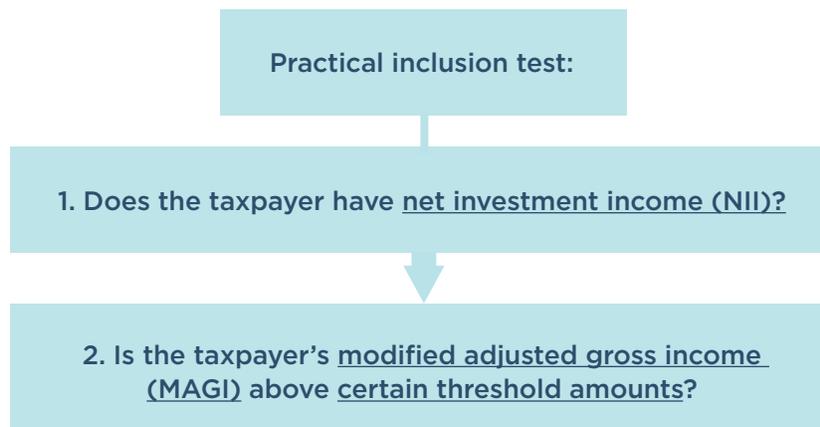
The tax went into effect January 1, 2013.

What is the tax rate?

The rate of the tax is 3.8%, which is on top of any other tax imposed.

Who pays the tax?

Taxpayers who meet a two part practical test are subject to the surtax.



If the answer to these two questions is yes, then some of the taxpayer's income will be subject to the surtax.

Let's look at the elements of this practical test.

What is Net Investment Income?

For the purposes of the surtax, the term net investment income means "investment income" reduced by any deductions allocable to such income. "Investment income" is defined as any: interest, capital gains, taxable annuity distributions, dividends, rents, royalties and passive activity income.

For the purposes of the surtax, “investment income” does not include: distributions from qualified plans or IRAs, self-employment income, gain on the sale of an active interest in a partnership or S-Corp and active trade or business income.

What is MAGI?

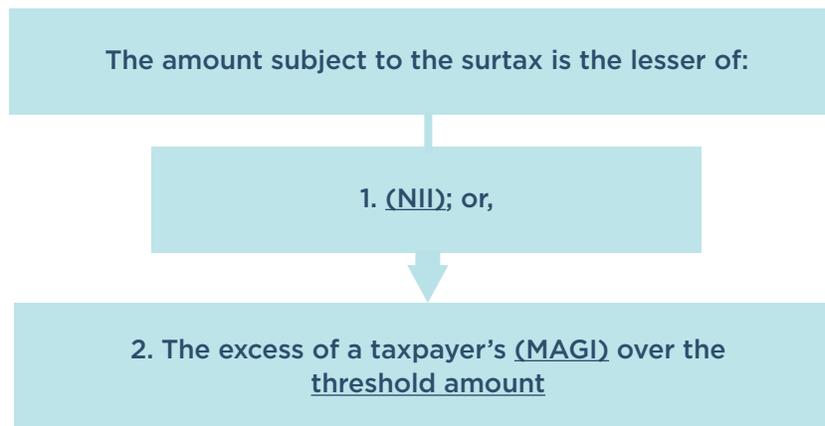
For the purposes of this rule, MAGI is total taxable income. Please note that distributions from qualified plans and/or IRAs, whether discretionary or required, are included in MAGI.

What are the threshold amounts?

Individual	\$200,000
Married filing jointly	\$250,000
Married filing separately	\$125,000
Married filing separately	Dollar amount of the highest tax bracket for that tax year
Trusts and Estates	\$12,500

How is the tax calculated?

Once it is determined that the taxpayer is subject to the surtax, then the taxpayer must determine how much of their total income will be subject to the surtax. This is done by applying another two part test.



Calculating the investment earnings surtax - Examples

Example #1

Richard and Mary are married taxpayers filing jointly. They have \$195,000 of taxable income from work and IRA distributions and \$175,000 of NII, for MAGI of \$370,000. Their investment earnings are a mix of net capital gains and ordinary income interest.

The first step is to determine if they are subject to the surtax. Because their total income is over \$250,000 and they have NII, they are subject to the investment income surtax.

The second step is to find out how much of their income will be subject to the surtax.

In this example, the amount subject to the surtax will be either the lesser of NII (\$175,000) or the excess of MAGI over the \$250,000 threshold ($\$370,000 - \$250,000 = \$120,000$). Thus the amount subject to the surtax is \$120,000.

The final step is to apply the surtax rate to the amount subject to the tax ($\$120,000 * .038 = \$4,560$). In this example, Richard and Mary will owe an additional \$4,560 in tax because of this new rule.

Example #2

Susan is a single taxpayer with \$320,000 of MAGI. She has \$100,000 of interest earnings from her investments and \$220,000 of earnings from work.

The first step is to determine if she is subject to the tax. Because her total income is over \$200,000 and she has NII, she is subject to the investment income surtax.

The second step is to find out how much of her income will be subject to the surtax.

In this example, the amount subject to the surtax will be either the lesser of NII (\$100,000) or the excess of MAGI over the \$200,000 threshold ($\$320,000 - \$200,000 = \$120,000$). Thus the amount subject to the surtax is \$100,000.

The final step is to apply the surtax rate to the amount subject to the tax ($\$100,000 * .038 = \$3,800$). In this example, Susan will owe an additional \$3,800 in tax because of this new rule.

Strategies to minimize or avoid the surtax

To minimize exposure to the surtax, there are two broad strategies to consider (1) reduce NII and thus MAGI or (2) strategies that only reduce MAGI. Within each of these broad strategies there are numerous investment alternatives and planning tactics to consider.

Strategies that reduce NII and MAGI

Tax exempt bonds

The interest on tax-exempt bonds is not NII and won't be included in MAGI, so clients may want to consider switching from taxable instruments like corporate bonds, certificates-of-deposit (CD) and money market funds to tax-exempt bonds.

Immediate annuities

Because immediate annuities payments are composed of a portion of return of cost basis, they can be a way for an individual to continue receiving a specific level of cashflow but pay less tax versus collecting a fully taxable bond coupon or sweeping fully taxable interest off a CD.

Distributions from life insurance policies

Withdrawals of cost basis and/or policy loans from the cash value of life insurance policies are not NII nor do they raise MAGI, creating non-taxable cashflow for the owner that will not be subject to the surtax.

Accumulation in deferred annuities

If the investor is still in the accumulation phase and paying taxes on their current accumulation investment vehicles, they may want to consider re-allocating those funds into a deferred annuity, which will allow the funds to accumulate income tax free. They would also be able to time when distributions are taken from the annuity to potentially take the withdrawals in years where their total income may be lower, so that the distributions of gain from the annuity, while taxable, are not subject to the surtax.

Accumulation in life insurance policies

Similar to deferred annuities, life insurance policies grow their cash values income tax free. The death benefit of life insurance is also received income tax free by the beneficiaries.

Rental real estate and oil and gas wells

As investments that can produce significant tax deductions, for example things like depreciation, maintenance, improvements, financing and intangible drilling costs, rental real estate and oil and gas wells can be a way to lower NII.

Charitable Remainder Trusts (CRT)

This technique allows the donor to spread out the taxation of the sale of donated property through the income payments they receive back from the trust and potentially minimize exposure to the surtax versus inclusion of the entire sale proceeds in NII and MAGI in the year of sale.

Installment sale

This technique would allow an investor to spread the sale proceeds of an investment, like a parcel of real estate, out over a term of years and potentially minimize exposure to the surtax versus inclusion of the entire sale proceeds in NII and MAGI in the year of sale.

Strategies that reduce MAGI

Roth IRA distributions

For investors that currently have money in a Roth IRA they may want to consider accessing the money inside the Roth IRA instead of accessing other pre-tax IRA or qualified plans accounts. Distributions from Roth IRAs can be taken income tax free and as such, do not raise an investor's MAGI.

Roth IRA conversion

If an investor does not currently have a Roth IRA, but is interested in using a Roth IRA in the future to minimize and/or avoid the surtax, then they could consider undertaking a Roth IRA conversion. The decision to convert is a cost/benefit calculation that the investor should weigh carefully before completing. Please be aware that a Roth conversion will increase MAGI in the year of conversion, which may expose NII to the surtax in the year of conversion.

Tax deductions

Certain types of deductions, like contributions to qualified plans and traditional IRAs, will reduce a taxpayer's MAGI.



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