Will my clients have to pay the new Medicare surtax?

By Editor Test *Sat, Aug 11, 2012*

If your clients' modified adjusted gross income (AGI) and their investment income combine to put them over one of the income thresholds, they will owe the tax. (Got questions? E-mail them to RIJ editor Kerry Pechter.)

If you're an advisor, many of your clients are likely to be subject to the 3.8% Medicare surtax that the 2010 Affordable Care Act makes effective starting in 2013. The tax is both old news and new news. In case you've ignored it until now, we provide the following summary.

First, a warning: your clients don't necessarily have to be extremely high earners to encounter this tax. If their modified adjusted gross income (AGI) and their investment income *combine* to put them over one of the income thresholds, they will owe the tax.

For instance, an individual with only $150,000 in wages but $70,000 in investment income would owe the surtax because her combined income of $220,000 puts her $20,000 over the $200,000 threshold for a single person. She'd owe $760 (.038 x $20,000). Spouses earning $110,000 each who have an additional $50,000 in investment income would also owe the surtax on the amount that their income exceeds $250,000, or $20,000.

Now here's the basic stuff you may or may not already know by heart:

The 3.8% surtax applies to whichever is *less*: a person's net investment income (dividends, rents, interest, capital gains, passive income, royalties, net of losses) or the amount of their modified adjusted gross income (including investment income) that exceeds certain thresholds. Distributions from qualified pension plans, nonqualified deferred compensation or municipal bond interest are not subject to the surtax, according to a report from BNY Mellon.

The aforementioned thresholds are $200,000 for individual taxpayers, $250,000 for married taxpayers filing jointly, and $125,000 for married taxpayers filing separately. Total income under these amounts isn't subject to the tax. Note that the thresholds aren't indexed for inflation. So, as wages grow, the amount exposed to the surtax will presumably grow.

The surtax applies to trusts and estates as well as to individuals. The annual surtax payable by a trust or estate is 3.8% of whichever is less: the undistributed net investment income or the excess of adjusted gross income over the amount at which the top income tax bracket for trusts and estates begins. The top bracket started at $11,200 for 2010, but will be indexed for inflation.

The Medicare surtax is not to be confused with next year's hike in the individual portion of the Medicare payroll tax. That tax, coincidentally, will also rise to 3.8% next year. It is currently 2.9% (with employer and employee each paying 1.45%). Starting in 2013, an additional 0.9% (for a total of 2.35%) will be levied on the portion of wages that exceeds $200,000 for single earners and $250,000 for couples.

Note: Moving assets into a tax-deferred annuity today can reduce or eliminate the surtax in future years by shielding investment income from taxes until after retirement, when your client's AGI may be far below the Medicare surtax threshold, says Robert Keebler, of Keebler Associates in Green Bay, Wis. "Some people are critical of that strategy because of the fees [associated with deferred annuities]," he said, but noted that fees needn't be prohibitive if you use a top-ranked insurer with competitive rates.