

# ACTIONABLE STRATEGIES FOR REDUCING MEDICARE TAXES

Medicare taxes increased in 2013 for high-income earners. Timely action can help reduce the impact of higher taxes.



## KEY TAKEAWAYS

High-income taxpayers face an additional 0.9% Medicare payroll tax on some wages and a 3.8% surtax on net investment income.



This paper includes a number of strategies – such as tax loss harvesting and capitalizing on employer plans – that can help to mitigate the impact of higher Medicare taxes.



Work with your financial advisor, alongside your accountant or tax advisor, to identify and implement the Medicare tax-planning strategies that are most advantageous for your situation.

## INTRODUCTION

On January 1, 2013, pursuant to the Health Care and Education Reconciliation Act of 2010, high-income taxpayers became subject to two additional Medicare taxes – an additional 0.9% Medicare payroll tax and a 3.8% Medicare surtax on net investment income.

As a result, it makes sense to include tax planning as part of your regular annual regimen, so you are not rushing to tidy up your tax position at year-end. After all, as we have seen in recent years, tax legislation is always changing. It is also recommended that you consult with your financial advisor, alongside an accountant or tax advisor, to help optimize your finances and keep more money in your pocket. The following pages provide a number of tax-planning strategies that can help mitigate the impact of higher Medicare taxes.

In addition to the new Medicare taxes, there have been a number of changes in other legislation that will affect certain individuals, their tax profile and how the following strategies may be applied. Specifically, in a landmark decision, the Supreme Court struck down Section 3 of the Defense of Marriage Act of 1996 and more recently legalized same-sex marriage in all 50 states. This allows same-sex married couples to receive the same federal benefits as other marriages. As a result, the income thresholds and strategies described in this white paper apply to all couples filing under a married status. It remains to be seen how the latest ruling will impact state income taxes.

## IMPORTANT DEFINITIONS

### HIGH-INCOME TAXPAYERS

These are single individuals with modified adjusted gross income (MAGI) in excess of \$200,000, or for married couples filing jointly, MAGI over \$250,000. MAGI is adjusted gross income – which is the last line on the front of the 1040 – increased by any net foreign earned income that was excluded from gross income.

### MODIFIED ADJUSTED GROSS INCOME FOR HIGH-INCOME TAXPAYERS



### NET INVESTMENT INCOME

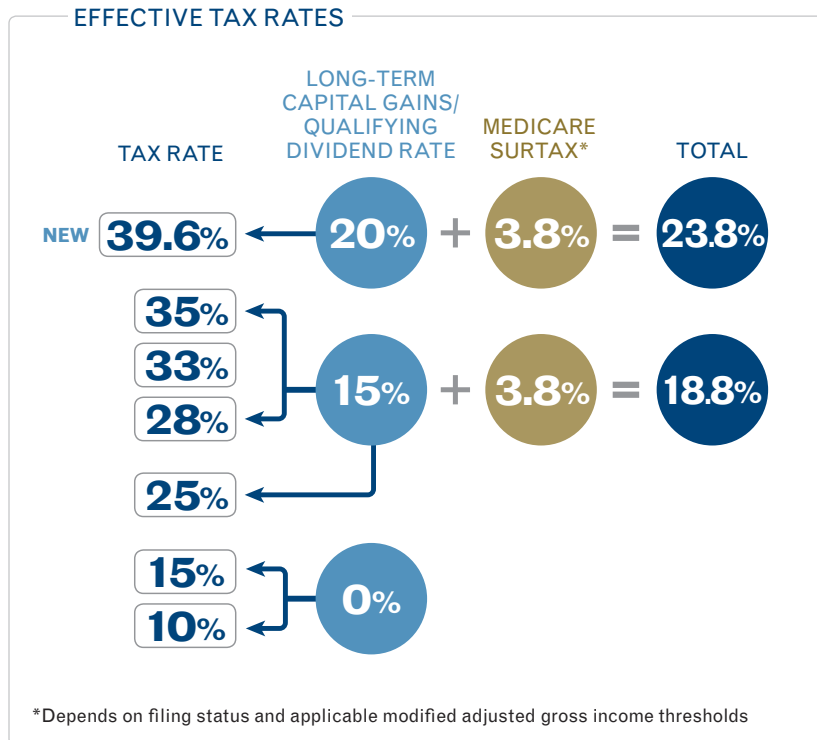
Net investment income (NII) consists of interest, dividends, annuities, royalties, rental income, passive activity income and capital gains, including capital gains from the sale of property less allowable deductions like advisory fees and commissions.

Note that NII does not include tax-exempt bond income, IRA or qualified retirement plan distributions, self-employment income, income from an active trade or business, or gain on the sale of an active interest in a partnership or S corporation. However, income from these sources may increase MAGI over the limits discussed above.

**NAVIGATING THE NEW FEDERAL TAX LANDSCAPE**

In addition to the higher Medicare taxes, you and your professional advisors will want to consider how the overall tax landscape changed for high-income earners. For example, the highest income tax bracket is now 39.6%, and the thresholds for the income tax brackets change each year.

In addition, for families in the 39.6% tax bracket, the tax rate on long-term capital gains and qualified dividend tax increased to 20% from 15%. Certain limitations on itemized deductions and personal exemptions were also reinstated as part of the 2013 tax legislation. The image below shows how taxpayers in the higher tax brackets will be affected by the capital gains tax and the additional 3.8% Medicare surtax that applies to net investment income.



Source: Forefield

Let's take a look at the details behind the two additional Medicare taxes high-income taxpayers may face. The first is the Medicare surtax.

### 3.8% MEDICARE SURTAX

The new 3.8% Medicare surtax applies to the net investment income for high-income taxpayers. The tax is calculated by taking 3.8% of your net investment income or the amount of modified adjusted gross income (MAGI) that exceeds the thresholds for high-income taxpayers – whichever is less. If either of these two numbers is zero, the tax is also zero.

#### HOW THE MEDICARE SURTAX WORKS

##### FILING SINGLE



**\$0**

Mary has \$50,000 in NII and \$100,000 of MAGI. She doesn't exceed the threshold, so she's not subject to the tax.

$$\begin{aligned} \text{Tax} &= 3.8\% \times (\text{Lesser of NII or MAGI} \\ &\quad \text{in excess of the } \$200,000 \text{ threshold}) \\ &= 3.8\% \times (\text{Lesser of } \$50,000 \text{ or } \$0) \\ &= 3.8\% \times \$0 = \mathbf{\$0} \end{aligned}$$

##### FOR A COUPLE



**\$950**

Pat and Kelly are filing jointly and have \$150,000 in NII and \$275,000 of MAGI.

$$\begin{aligned} \text{Tax} &= 3.8\% \times (\text{Lesser of NII or MAGI} \\ &\quad \text{in excess of the } \$250,000 \text{ threshold}) \\ &= 3.8\% \times (\text{Lesser of } \$150,000 \text{ or } \$25,000) \\ &= 3.8\% \times \$25,000 = \mathbf{\$950} \end{aligned}$$



**\$4,750**

Chris and Tracy have just sold their principal residence for a net gain of \$700,000 – \$500,000 of that gain is sheltered by the home sale exclusion. This leaves them with \$200,000 of NII. They earn \$175,000 a year. They therefore have \$375,000 of MAGI (\$175,000 salary and a \$200,000 net gain). So they'll have to pay this tax.

$$\begin{aligned} \text{Tax} &= 3.8\% \times (\text{Lesser of NII or MAGI} \\ &\quad \text{in excess of the } \$250,000 \text{ threshold}) \\ &= 3.8\% \times (\text{Lesser of } \$200,000 \text{ or } \$125,000) \\ &= 3.8\% \times \$125,000 = \mathbf{\$4,750} \end{aligned}$$



#### A CAUTIONARY NOTE


Be aware that your employer must withhold the tax based on the higher rate (2.35%) if your wages are higher than \$200,000; however, employers aren't responsible for determining whether you AND your spouse are subject to the tax if your combined income takes you over the couple threshold. This means that if you earn less than \$200,000 a year, but together with your spouse you earn more than \$250,000, then you will be responsible for paying the additional Medicare payroll tax. On the other hand, if you were taxed on individual wages in excess of \$200,000, but the income on your joint tax return is less than \$250,000, you will get a tax credit for the amount overpaid.

## 0.9% MEDICARE PAYROLL TAX

The second Medicare tax applies to wages and self-employment income that exceed the MAGI thresholds. The percent of Medicare tax you pay on wages in excess of the threshold increases from the standard 1.45% to 2.35% – a 0.9% increase.

### HOW THE MEDICARE PAYROLL TAX WORKS

#### FILING SINGLE


 John earns \$250,000 in wages each year.

**Old tax**  
 $(1.45\% \times \$250,000) = \$3,625$

**\$450 New tax**  
 $[(1.45\% \times \$200,000) + (2.35\% \times \$50,000)] = \$4,075$

**Tax Increase = \$450**

#### FOR A COUPLE

 Alex and Jessie are filing jointly; Alex earns \$160,000 and Jessie earns \$240,000. (Joint wages of \$400,000 reach high-income threshold.)

**\$1,350 Employer withholding for:**

**Alex**  $(\$160,000 \times 1.45\%) = \$2,320$

**Jessie**  $(\$240,000 \times 1.45\%) = \$3,480$

**Combined Medicare tax withholding: \$5,800**

**Additional amount not withheld and due with tax return:**  
 $[(\$400,000 - \$250,000) \times 0.9\%] = \mathbf{\$1,350}$

Note that this is an example where an employer didn't deduct the additional amount over \$200,000 (whether married filing jointly or not) for Alex.

## TAX SAVINGS STEPS TO TAKE

There are a number of tax planning strategies that can help to mitigate the impact of higher Medicare taxes. While these are meant to reduce Medicare taxes specifically, many of these tactics can also help lower your overall taxes.

### No. 1 **MANAGE YOUR PORTFOLIO AND IMPROVE ITS TAX EFFICIENCY**

Tax efficiency is essential to maximizing portfolio returns. Simply put, tax efficiency is measured by how much of an investment's return remains after taxes are paid. Certain investments generate more taxable distributions than others. Work with your advisor to evaluate your investments and after-tax returns.

To get a sense of your annual tax liability and take steps to add more tax-efficient investments, it's important to review your portfolio's turnover ratio (the percentage of your holdings that have been replaced in a given year) and historical distributions.

#### Other steps that may help to reduce taxes include:

- ▶ **Engage in tax loss harvesting**  
Selling securities at a loss to offset capital gains tax liability is an effective way to offset realized gains.
- ▶ **Rebalance your portfolio**  
Include more tax-advantaged investments such as municipal bonds or dividend-paying stocks, especially in higher tax brackets.
- ▶ **Review the cost basis, or original value, of your securities**  
Ensure accuracy and avoid paying too much tax.
- ▶ **Target companies offering non-dividend stocks**  
They typically engage in stock buybacks, which is when a company repurchases outstanding shares to reduce the number of shares on the market.

#### TIP

When rebalancing your portfolio, consider using new money coming into the account versus selling off certain investments to avoid incurring unnecessary capital gain taxes. Alternative sources include bonus money, gifts or stock option conversions.

While interest on municipal bonds is generally exempt from federal income tax, it may be subject to the federal alternative minimum tax, or state or local taxes. Profits and losses on federally tax-exempt bonds may be subject to capital gains tax treatment. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax.

Dividends are not guaranteed and will fluctuate.

**No. 2 CAPITALIZE ON EMPLOYER SALARY DEFERRAL AND HEALTH SAVINGS PLANS**

If your employer offers a salary deferral plan like a 401(k), SIMPLE IRA, 403(b) or 457 plan, maximize your contributions to reduce your adjusted gross income and taxes over the long term. Similarly, maximize contributions to an employer supplemental employee retirement plan (SERP) to reduce your taxable income now and defer the compensation into later years when your tax rate may be lower.

You can also reduce your taxable income by contributing to an employer health savings plan or flexible spending account. Not only can it help you prepare for medical events, it also uses pre-tax dollars, reducing your taxable income. Additionally, the IRS now allows a \$500 flexible spending account carryover into future years.

**TIP**

Tax planning strategies may help you reduce your overall tax bill, but don't lose sight of your risk tolerance and long-term financial goals.

**No. 3 USE IRA AND ROTH IRA STRATEGIES TO REDUCE TAXES IN FUTURE YEARS**

Fully funding a nondeductible IRA may not immediately reduce your adjusted gross income, but there is a possibility it could in future years. You also may want to consider a Roth IRA conversion, which will reduce your MAGI in later years since Roth distributions are excluded from net investment income. Keep in mind, though, that your adjusted gross income will increase in the year of conversion, which will increase your MAGI and potentially subject more of your net investment income to the surtax in the year of the conversion.

Rolling from a traditional IRA into a Roth IRA may involve additional taxation. When converted to a Roth, the client pays federal income taxes on the converted amount, but no further taxes in the future. Unless certain criteria are met, Roth IRA owners must be 59½ or older and have held the IRA for five years before tax-free withdrawals are permitted. Additionally, each converted amount is subject to its own five-year holding period. Investors should consult a tax advisor before deciding to do a conversion.

**No. 4 BUSINESS OWNERS CAN TAKE ADVANTAGE OF A NON-QUALIFIED DEFINED CONTRIBUTION PLAN**

If you are a business owner, consider establishing a non-qualified defined contribution (NQDC) plan in addition to a defined benefit pension plan to help defer taxes on growth investments.

**No. 5 DEVELOP A CHARITABLE GIVING PLAN**

Charitable giving can reduce your tax burden and also provide a sense of satisfaction by benefiting your favorite causes. Generally, donations to qualified charities count as an itemized deduction for that tax year. This includes cash, real estate, goods or other assets. The deductibility of charitable gifts is based on several factors, such as the donor's income, the nature of the donation and the charity receiving the donation. A sound plan can help offset an increase in taxes.

**When creating a charitable plan, consider these options:**

- Give appreciated securities that you've held for more than 12 months to avoid capital gains, which increase your net investment income.
- Establish a donor advised fund to make future donations and claim the current income tax deduction.
- Contribute highly appreciated assets to a charitable remainder trust (CRT) to defer recognition of income over time.

**No. 6 INVEST IN A PERMANENT LIFE INSURANCE POLICY**

Investing in yourself and your family with a permanent life insurance policy can provide several benefits. In addition to the protection and assurance that your family will be taken care of in the event of death, accumulating cash value in life insurance also can offer tax-deferred growth and tax-advantaged retirement income.

**No. 7 OTHER TACTICS**

- Shift income by gifting to family members in lower marginal tax brackets.
- Achieve tax benefits by selling qualifying assets via an installment sale or using income smoothing strategies to defer gain recognition and taxes.
- Non-security investments, like real estate and oil & gas, can provide tax advantages including depreciation deductions and the sheltering effect of depletion.

Investing involves risks, including the potential loss of capital. Commodities are generally considered speculative because of the significant potential for investment loss. Commodities are volatile investments and should only form a small part of a diversified portfolio. There may be sharp price fluctuations even during periods when prices overall are rising. The value of real estate investments may be adversely affected by several factors, including supply and demand, rising interest rates, property taxes, and changes in the national, state and local economic climate.

Note: These tactics may help reduce taxes, but they're not for everyone. Consult a tax professional.



**ADMINISTRATION OF TRUSTS AND ESTATES**

When it comes to estate planning, be aware that modest estates may be subject to the 3.8% Medicare surtax. This is because the surtax threshold for trusts and estates remains very low – \$12,300 for 2015 – compared with the MAGI thresholds of \$200,000 for single individuals and \$250,000 for married couples. Also, capital gains are generally trapped at the trust/estate level, increasing net investment income, which may quickly exceed the same threshold.

**In order to minimize the 3.8% Medicare surtax, trustees and estate executors may want to consider the following planning opportunities:**

- Rather than accumulating income inside the trust, distribute the income (in line with trust terms and fiduciary duties) to beneficiaries, particularly those below the MAGI thresholds. This essentially shifts the income and the resulting tax burden from the trust/estate to the beneficiary, the surtax is avoided on that income amount, assuming the beneficiary is below the MAGI threshold.
- Consider a trust income tax election under 663(b), which allows any distributions occurring within 65 days of year-end as made for income tax purposes during the preceding year. This allows for more flexible tax planning by the trustee or executor of an estate and avoids the potential surtax at the estate/trust level.

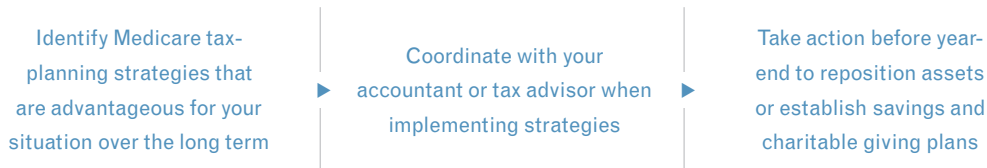
Estate/trust planning and its management can be complex. These are general ideas for reducing the Medicare surtax and may not apply to every situation. It is strongly recommended that you work with not only your financial advisor, but also a trust and estate professional when making decisions about your estate and beneficiary distributions.

## CONCLUSION

Creating a tax strategy is important. It is equally important that you don't make changes to your investment portfolio or financial plan based on the Medicare tax considerations alone. There are a number of factors to think about and you should consider strategies that fit within your overall risk tolerance and long-term financial plan. The key to managing your tax burden is planning ahead, so take action as soon as possible, preferably before the end of the year.

If after considering these strategies, your modified adjusted gross income still exceeds the high-income thresholds, keep in mind that many of these tactics can help reduce your overall taxable income and tax liability. Together with your Raymond James financial advisor, you can review how various strategies may impact your personal situation. Your advisor can also work with your accountant or tax professional to coordinate appropriate tax strategies.

## WORK WITH YOUR FINANCIAL ADVISOR



As you consider your tax-planning strategy, remember that establishing your personal financial goals for both the short and long term is most critical. Tax strategies (such as the ones described throughout this paper) can be used to help you achieve these goals, but they should be utilized within the context of your overall financial picture.

**LIFE WELL PLANNED.**

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