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Tax and Business Alert™

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Minimizing the 3.8% Net Investment Income Tax

Higher income taxpayers beware. There is a new surtax to contend with. Originating as a component of 2010 health care legislation and first effective in 2013, the 3.8% net investment income tax (3.8% NIIT) is assessed on the *lesser* of net investment income (NII) or modified adjusted gross income (MAGI) above specific thresholds. The MAGI thresholds are $200,000 for single individuals, $250,000 for joint filers and surviving spouses, and $125,000 for married taxpayers filing separate returns.

Only individual taxpayers with some amount of NII and MAGI above the applicable threshold amount will be subject to the 3.8% NIIT. In other words, taxpayers with only wage or self-employment income are exempt. For example, if a married couple has $500,000 of wage income and $100,000 of interest and dividend income (i.e., MAGI totaling $600,000), the 3.8% NIIT only applies to the investment income ($100,000), not the $350,000 that is over the $250,000 MAGI threshold.

Since the 3.8% NIIT is assessed on the lesser of NII or MAGI above the threshold, planning strategies to reduce the surtax will only be effective if they target the applicable exposure point. If NII is the lower number, planning strategies should focus on reducing investment income. If the taxpayer's MAGI is lower, reduction strategies should focus on reducing AGI. The following strategies can be used to reduce NII and AGI.

NII can be reduced currently by:

- Selling securities at a loss in a taxable account (also reduces AGI).
- Using an installment sale to spread a large gain over several years (also reduces AGI).

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- Facilitating a like-kind exchange to defer gain (also reduces AGI).
- Gifting appreciated securities instead of cash (also reduces AGI).

AGI can be reduced currently by:

- Maximizing deductable contributions to a tax-favored retirement account, i.e., 401(k), SEP, and defined benefit pension plans.
- For cash-basis self-employed individuals, deferring business income into the following year and accelerating business deductions into the current year.
- Gifting appreciated securities to children and letting them sell the appreciated securities to avoid recognizing gains on the parent's

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Year-end Mutual Fund Purchases

Many taxpayers make adjustments to their investment portfolio near year-end to take profits, to recognize tax losses, to reallocate their assets, and for various other reasons. When making purchases of mutual funds near year-end, however, you should be wary of actually purchasing a tax liability.

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This is the danger: mutual funds must pay out their gains and income to shareholders at least annually to avoid taxation at the fund level. Income funds and balanced funds typically make taxable distributions to shareholders either monthly or quarterly. However, equity funds often make one annual distribution at or near the fund's year-end. These taxable distributions to shareholders reflect the income and net gains realized by the fund for the period.

An equity fund that appears to have a minimal or negative overall return for the year may actually make taxable distributions to shareholders at the end of the year. This is because of gains the fund recognized on appreciation that occurred in prior years. From an investor's standpoint, these distributions do not result in any real net benefit; instead, the distributions are already reflected in the fund's per share value. So after a distribution is made, the share value is reduced accordingly.

Because of the income distributions mutual funds must make, the timing of a share purchase in a particular fund can affect your tax liability. Purchasing shares just before the record date (i.e., the date that determines which shareholders will receive the distribution) is

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return (also reduces the parent's NII). Be aware that the Kiddie Tax may apply; however, the child will receive his or her own MAGI exemption from the 3.8% NIIT.

Longer-term strategies:

- Convert traditional retirement account balances to Roth IRAs, but watch out for the AGI impact in the conversion year. In the long run, gains and earnings that build up tax-free in a Roth IRA are not included in either AGI or NII when eventually distributed.

- Invest in tax-exempt versus taxable bonds, which will reduce both AGI and NII.

- Use tax-favored retirement accounts to invest in securities that are expected to generate otherwise-taxable gains and dividends.

- Invest in life insurance and tax-deferred annuity products. Life insurance death benefits are generally exempt from ordinary income tax and, thus, from the 3.8% NIIT, as well. Death benefits will not increase the recipient's exposure to the 3.8% NIIT by increasing his or her AGI.

- Invest in rental real estate and oil and gas properties. Depreciation, intangible drilling costs, and depletion deductions reduce both AGI and NII.

- Invest in growth stocks and defer gains until the stocks are sold; offset gains with losing positions.

These are some of the ways to reduce exposure to the 3.8% NIIT. Please contact us if you have questions or need additional information to eliminate or minimize your exposure to this new surtax.

Qualified Charitable Distributions

IRA owners and beneficiaries who have reached age 70½ are permitted to make donations to IRS-approved public charities directly out of their IRAs. These so-called qualified charitable distributions, or QCDs, are federal-income-tax-free to you, but you get no charitable deduction on your tax return. But, that is fine because the tax-free treatment of QCDs is the same as an immediate 100% deduction without having to worry about restrictions that can delay itemized charitable write-offs. QCDs have other tax advantages, too.

A QCD is a payment of an otherwise taxable distribution made by your IRA trustee directly to a qualified public charity. The funds must be transferred directly from your IRA trustee to the charity. You cannot receive the funds yourself and then make the contribution to the charity. However, the IRA trustee can give you a check made out to the charity that you then deliver to the charity. You cannot arrange for more than $100,000 of QCDs in any one year. If your spouse has IRAs, he or she has a separate $100,000 limitation. Unfortunately, this taxpayer-friendly provision is set to expire at year-end unless extended by Congress.

Before Congress enacted this beneficial provision, a person wanting to donate money from an IRA to a charity would make a withdrawal from his or her IRA account, include the taxable amount in gross income, donate the cash to charity, and then claim an itemized charitable donation.

QCDs are not included in your adjusted gross income (AGI) on your federal tax return. This helps you remain unaffected by various unfavorable AGI-based phase-out rules. It also keeps your AGI low for computation of the 3.8% NIIT. In addition, you don't have to worry about the 50%-of-AGI limitation that can delay itemized deductions for garden-variety cash donations to public charities. QCDs also count as payouts for purposes of the required minimum distribution (RMD) rules. Therefore, you can donate all or part of your 2013 RMD amount (up to the $100,000 limit on QCDs) and thereby convert otherwise taxable RMDs into tax-free QCDs. Individuals can arrange to simply donate amounts that they would normally be required to receive (and pay tax on) under the RMD rules.

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Note that the charity must provide you with a record of your contribution. Also, you cannot receive any benefit from the charity in return for making the contribution. If the donor receives any benefit from the charity that reduces the deduction under the normal rules, tax-free treatment is lost for the entire distribution.

Year-end Mutual Fund Purchases

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essentially purchasing a tax liability. This is because the (inflated) price of the shares just before the distribution includes the income that is about to be paid out.

When the distribution is made, the price per share falls, though the total investment value remains the same (i.e., if the income distribution is reinvested, the shareholder now owns more shares with a lower value per share; if the income is distributed, the cash received plus the share value equals the shareholder's investment before the distribution). Thus, mutual fund investors should pay particular attention to when they invest. This is especially true for equity funds that make only one distribution each year. So be sure to check with the mutual fund company to determine the status and nature of any forthcoming dividends when purchasing equity mutual funds late in the year to avoid an unexpected tax liability.

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Itemized Medical Deductions

Before this year, you could claim itemized deductions for medical expenses paid for you, your spouse, and your dependents to the extent those expenses exceeded 7.5% of your adjusted gross income (AGI). But the rules have changed for the worse in 2013 and beyond.

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Due to the 2010 Affordable Care Act, the old 7.5%-of-AGI hurdle is now 10% for most taxpayers in 2013. An exception applies for taxpayers, or their spouse if married, who are age 65 or older on December 31. They can still use the 7.5%-of-AGI threshold through 2016.

Many individuals have flexibility regarding when certain medical expenses will be incurred. They may benefit from concentrating expenses in alternating years. That way, an itemized medical expense deduction can be claimed every other year instead of lost completely if it doesn't exceed the threshold.

Medical expenses paid for a taxpayer's dependent, such as a parent or grandparent, can be added to the taxpayer's own expenses for itemized medical expense deduction purposes. For a person (other than a qualified child) to be the taxpayer's dependent, the taxpayer must pay more than half of that person's support for the year. If that test is passed, the taxpayer can include medical expenses paid for the supported person—even if the taxpayer cannot claim a dependency exemption for that person. While the taxpayer must still clear the applicable AGI threshold to claim an itemized medical expense deduction, including a supported person's expenses in the computation can really help.