<u>WILLMS, S.C.</u>
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LAW FIRM

TO: Clients and Friends of Willms, S.C.

FROM: Attorney Maureen L. O'Leary

DATE: June 7, 2012

RE: New Taxes to Take Effect in 2013

The following two new taxes will take effect on January 1, 2013:

1. **Investment Income Tax** - A new 3.8% tax on investment income, and

2. **Earned Income Tax** - A new 0.9% tax on earned income

Both of these taxes are imposed by the Health Care and Education Reconciliation Act of 2010. The new taxes are often referred to as "Medicare taxes" because the proceeds will be allocated to the Medicare Trust Fund (part of the Social Security System). These taxes are intended to assist the Medicare Trust Fund in meeting its financial obligations. Some commentators have reported that if it were not for these new taxes, the Medicare Trust Fund might run out of money as early as 2016.

The new taxes only apply to "high income" taxpayers. High income taxpayers are defined as single taxpayers with an adjusted gross income above $200,000 or married taxpayers filing jointly with a combined adjusted gross income above $250,000 (or $125,000 per spouse if married filing separate returns). If your gross income is less than these amounts, you will not be subject to the new taxes.

<u>3.8% Investment Income Tax</u>

The new 3.8% tax will be applied to the lesser of the taxpayer's total net investment income or the taxpayer's excess of AGI over the $200,000 or $250,000 threshold amounts.

Net investment income includes interest, dividends, capital gains (less capital losses), annuities, royalties, and rents that are not derived in the ordinary course of an active trade or business. It also includes proceeds from the sale of personal real estate.[1]

Net investment income that flows from a pass-through entity (such as an LLC or S-Corporation) to its owners will retain its character as net investment income and be subject to the new 3.8% Medicare tax on the owner's tax returns.

"Net" investment income is gross investment income reduced by investment expenses. Investment expenses reduce the amount of investment income subject to the tax.

Unlike other federal income tax, a charitable deduction is not allowed against this tax. The tax can only be minimized by minimizing the investment income.

Following are some strategies for avoiding the 3.8% investment income tax:

1. Consider selling highly appreciated assets in 2012, before the tax becomes effective in 2013.

2. Minimize net investment income by increasing investment expense deductions.

3. Maximize contributions to IRAs (including Roth IRAs and other qualified requirement plans), because the tax does not apply to distributions from these plans.

4. Consider investing in tax exempt and tax-deferred vehicles like municipal bonds, tax deferred non-qualified annuities, life insurance and non-qualified deferred compensation, as income from these sources is not subject to the tax.

5. Focus on generating income from active trades or businesses, to which the lower 0.9% Earned Income Tax applies, instead of the higher 3.8% Investment Income Tax.

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[1] The $250,000/$500,000 exclusion of gain from certain qualified principal residences will continue to apply. The new 3.8% tax will not apply to this excluded amount of gain.

0.9% Earned Income Tax

The new 0.9% tax does not apply to investment income. Instead, it applies to all earned income that exceeds $200,000 for single taxpayers or $250,000 for married taxpayers filing jointly (or $125,000 if married filing separate returns).

Earned income includes wages and income from a trade or business.

Currently, earned income is subject to a 2.9% Medicare Tax. Employees pay 1.45% (half of the 2.9% rate) by withholdings from their paycheck and employers pay the other 1.45%. Self-employed individuals pay the entire 2.9% themselves.

When the additional 0.9% Earned Income Tax becomes effective in 2013, it will essentially increase the Medicare Tax on earned income from 2.9% to 3.8% (2.9% + 0.9% = 3.8%).

The new 0.9% Earned Income Tax is imposed on the employee (it does not increase the amount due by the employer). However, employers will be required to withhold an additional 0.9% of employees' wages in excess of the threshold amounts. Employers may be subject to interest and penalties if they fail to withhold the additional 0.9% tax.

END OF MEMO