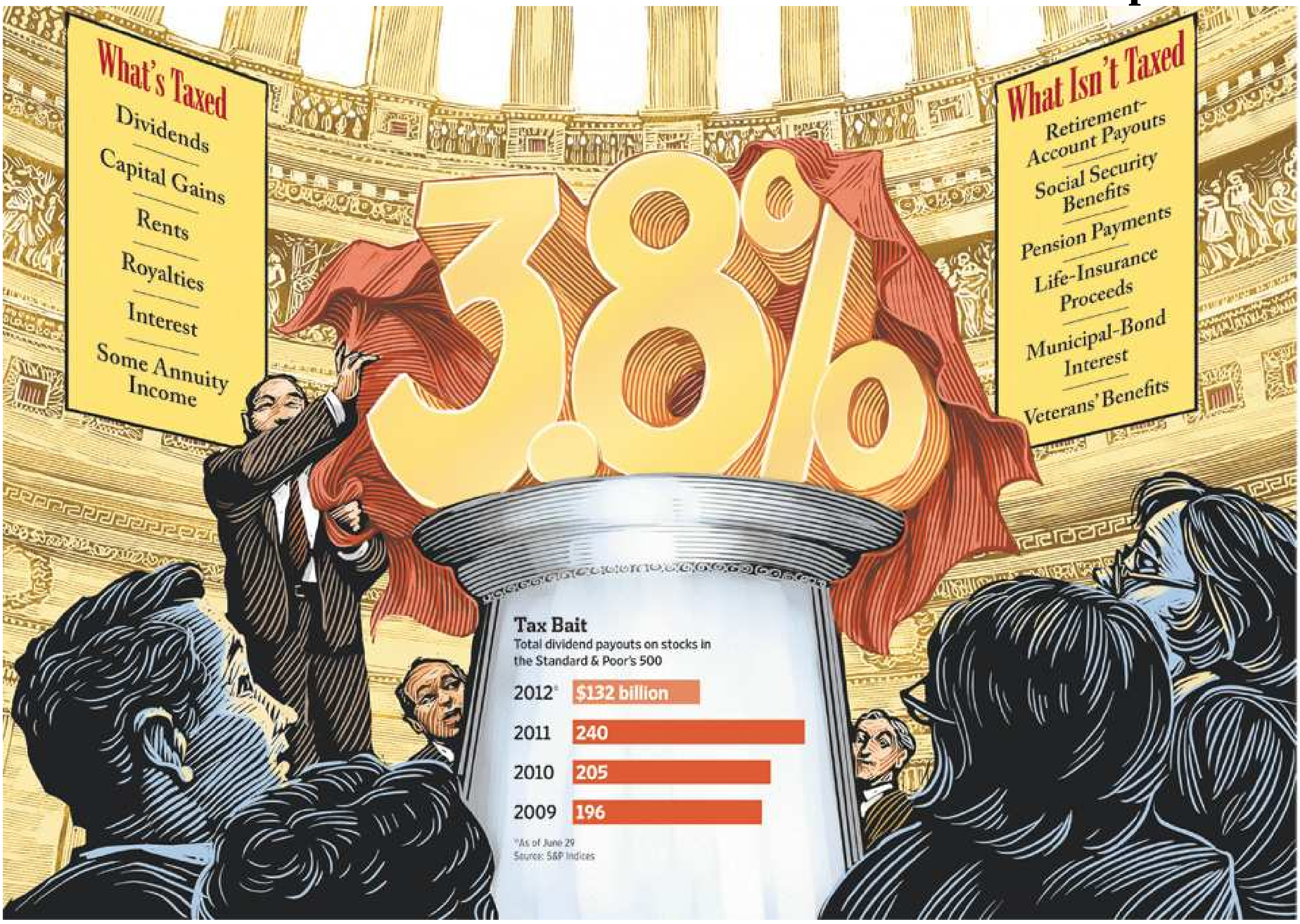
THE WALL STREET JOURNAL

June 30, 2012 – WEEKEND INVESTOR – By Laura Saunders

Behold the New Investment Tax

The Supreme Court's Health-Care Ruling Means the 3.8% Surtax On Investment Income Is for Real. Here's How to Prepare



It really is happening.

Until this week, investors were waiting to see what the Supreme Court would do about the 3.8 percentage-point surtax on investment income, part of President Obama's health-care overhaul. The Internal Revenue Service hasn't yet released guidance on the new tax.

So when the court affirmed the law on Thursday, investors—and tax advisers—started scrambling.

The new tax, which Congress passed in 2010, affects the net investment income of most joint filers with adjusted gross income of more than $250,000 ($200,000 for single filers). Starting on Jan. 1, 2013, the tax rates on long-term capital gains and dividends for these earners will jump from their current historic low of 15% to 18.8%, assuming Congress extends the current law.

If, on the other hand, Congress allows the tax rates set in 2001 and 2003 to expire on Dec. 31—an unlikely scenario, according to many experts—the top rate on capital gains will rise to 23.8% and the top rate on dividends will nearly triple, to 43.4%.

Whatever the fate of the 2001-03 tax rates, advisers are telling clients to start making moves to minimize the new levy.

Adjusted gross income is the number at the bottom of the front page of form 1040; it includes interest, dividends, capital gains, wages and retirement income plus results from partnerships and small businesses, but it doesn't include subtractions for itemized deductions such as mortgage interest and charitable gifts, or personal exemptions.

The new levy is complex, but in effect it is a flat tax on investment income above the $250,000/$200,000 threshold. Note that while the tax applies only to investment income above the threshold, other income—such as wages or Social Security—can raise adjusted gross income, making investment income more vulnerable to the tax. (See the examples below.)

Absent guidance from the IRS, experts believe the tax applies to dividends; rents; royalties; interest, except municipal-bond interest; short- and long-term capital gains; the taxable portion of annuity payments; income from the sale of a principal home above the $250,000/$500,000 exclusion; a net gain from the sale of a second home; and passive income from real estate and investments in which a taxpayer doesn't materially participate, such as a partnership.

The tax doesn't include payouts from a regular or Roth IRA, 401(k) plan or pension; Social Security income; or annuities that are part of a retirement plan. Also not included are life-insurance proceeds; municipal-bond interest; veterans' benefits; Schedule C income from businesses; or income from a business on which you are paying self-employment tax, such as a Subchapter S firm or a partnership.

Comments June 30, 2012
One of the easiest ways to avoid the 3.8% surtax on investment income is to reduce your adjusted gross income (AGI) to $250,000 ($200,000 for single filers). No, I am not suggesting you compromise your income simply to avoid taxes on your income. I am suggesting you take advantage of your employer sponsored retirement plan to reduce your AGI. A potentially greater benefit of reducing your AGI is the reduction in income taxes. Let's look at a few examples.

Example 1 – Single Person Age 50 Working at a Company
When you contribute $22,000 to your 401(k) you reduce your AGI by $22,000. This contribution reduces your AGI from $220,000 to $200,000 and eliminates the surtax.

Example 2 – Husband and Wife Each Age 50 Working at Companies
When you each contribute $22,000 to your 401(k) you reduce your combined AGI by $44,000. These contributions reduce your AGI from $294,000 to $250,000 and eliminate the surtax.

Example 3 – Husband and Wife Each Age 50 Working at Public Schools
When you each contribute $22,000 to your 403(b) you reduce your combined AGI by $44,000. When you each simultaneously contribute $22,000 to your 457(b) you reduce your combined AGI by another $44,000. The contributions to both retirement plans reduce your AGI from $338,000 to $250,000 and eliminate the surtax.

Although retirement account withdrawals are not subject to the surtax, they could be subject to income taxes. **Fortunately, there are additional estate planning and financial planning strategies to avoid required minimum distributions (RMDs). As a result, these strategies avoid income taxes and the surtax.**

Aaron Skloff, AIF, CFA, MBA
CEO - Skloff Financial Group

Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA), is the Chief Executive Officer of Skloff Financial Group, a NJ based Registered Investment Advisory firm. The firm specializes in financial planning and investment management services for high net worth individuals and benefits for small to middle sized companies. He can be contacted at www.skloff.com or 908-464-3060.