

Money Matters

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How to Avoid New Investment Surtax

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Q: What is the new investment surtax and how can we avoid some or all of it?

The Problem - New Investment Surtax Can Cost You 3.8%

Effective Jan. 1, 2013, you may pay an additional 3.8% surtax on your investment income.

If you file your taxes as a single person and your adjusted gross income (AGI) is \$200,000 or greater or if you file your taxes jointly and your AGI is \$250,000 then you are the target of this new tax.

As it applies to the new rules, investment income includes: dividends, rents, royalties, interest, short term and long term capital gains and taxable annuity payments. The surtax applies to the income above \$200,000 or \$250,000, respectively.

Although 3.8% may not seem like a large additional tax it is important to know what the current tax rate is on some of the most common sources of income being impacted. Specifically, the tax rate on most dividends and long term capital gains is 15.0%. The surtax translates to an over 25% ($3.8\% / 15.0\%$) increase in the actual taxes paid on the impacted income.

Although the following items may increase your AGI and increase the amount of surtax you may pay they are not subject to the surtax: wages, self-employment income; distributions from IRAs, Roth IRAs and company retirement plans, municipal bond interest, death benefit proceeds from life insurance policies, veterans' benefits and Social Security income.

The Solution — Reduce Your Adjusted Gross Income (AGI) and Increase Your Retirement Savings

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 for joint filers (\$200,000 for single filers). I am not suggesting you compromise your income to avoid taxes. 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.

Example 1 — Single Person Age 50 Working at a Company. When you contribute \$22,000 (\$17,000 if under age 50) 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 (\$17,000 if under age 50) 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 (\$17,000 if under age 50) to your 403(b) you reduce your combined AGI by \$44,000. When you each simultaneously contribute \$22,000 (\$17,000 if under age 50) to your 457(b) you reduce your combined AGI by another \$44,000. These contributions 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.

Another way of reducing your AGI, avoiding the surtax and creating a tax free savings account to pay medical costs and long term care insurance premiums is to contribute to your employer sponsored Health Savings Account (HSA).

When you contribute to your employer sponsored retirement account you can accomplish two goals simultaneously – create a healthy retirement nest egg and avoid the surtax.

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