The tax implications of the health care law: *Are you ready for a 3.8 percent surcharge tax?*

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When the U.S. Supreme Court ruled on the health care law late last month, the decision upholding the individual health insurance mandate made headlines.

But lost in the details and unknown to many was the 3.8 percent surcharge tax on net investment income set to take effect Jan. 1, 2013.

"The only people I have been having conversations about this with are accountants," said Bernard A. Krooks, a partner with an estate planning practice at Littman Krooks in Manhattan and White Plains, N.Y. "Clients have no idea."

Robert Keebler, a CPA with Keebler & Associates in Green Bay, Wis., agreed. "Everybody has been burying their heads in the sand on this, hoping that it was going to go away" if the Supreme Court struck down the health care law, he said. "But now that we have the Court's decision, we have to confront [the tax] immediately as it starts not even six months from now."

To avoid the imposition of the surcharge, taxpayers need to begin planning now.

"Every attorney doing estate planning should, at a minimum, be having a conversation about [the surcharge] with their clients," said Ed Slott, a CPA in Rockville Centre, N.Y., who publishes *Ed Slott's IRA Advisor*. "This is the catalyst most people need to talk about their assets and estate planning."

What is the tax?

Beginning Jan. 1, 2013, all net investment income will be taxed an additional 3.8 percent.

Investment income is broadly defined to include income from bonds, stocks, mutual funds, annuities, dividends, rents, royalties, property and capital gains.

The tax will apply to trusts and estates with income over $11,200 as well as taxpayers with an adjusted gross income of $200,000 (individuals) or $250,000 (married couples filing jointly).

The surcharge applies to 1) the excess of adjusted gross income over those amounts, or 2) net investment income, whichever is less.

So if a taxpayer's adjusted gross income totaled $205,000 and he had investment income of $3,000, then the 3.8 percent tax would apply only to the $3,000, Krooks said. Alternatively, if the same individual's AGI totaled $205,000 but he or she had $10,000 in investment income, the $5,000 would be taxed, he explained.

The Internal Revenue Service has yet to issue regulations for the surcharge, most likely because the agency was waiting to see if the law would be upheld, Krooks said.

But "regulations will be required," he added, and will hopefully provide guidance for practitioners.

Slott noted that the surcharge isn't the only tax change coming in 2013.

The expiration of tax cuts also takes effect next year and the tax on dividends will more than double from its current 15 percent, he said.

That means a high-bracket taxpayer receiving a dividend in 2013 could face a tax of 43.4 percent – 39.6 percent plus the 3.8 percent surcharge – an almost 200 percent increase.

Two strategies for avoidance

There are two strategies to avoid or decrease the impact of the surcharge, Keebler said.

One method: limit taxpayers' adjusted gross income to below the threshold amounts.

Because the tax is predicated upon an AGI of more than $200,000 or $250,000, taxpayers can re-allocate funds, such as by making contributions to qualified retirement plans or using various techniques involving life insurance, Keebler said. That way, their income decreases and so does the potential tax liability.

A second method involves limiting the amount of net investment income.

In this scenario, taxpayers re-allocate their investments from stocks, for example, and put the funds into tax-free vehicles such as a Roth IRA.

Michael J. Jones, a CPA and estate planner at Thompson Jones in Monterey, Calif., also noted that when a taxpayer takes a required minimum distribution, which isn't in and of itself subject to the 3.8 percent surtax, those funds should also be put into protected accounts, so they will not be subject to the surcharge later.

Re-allocations will likely require taxpayers to pay tax now as they remove money from the current investment, however, which could cause some clients to hesitate.

While it may seem odd to pay taxes to avoid a tax, paying at a lower rate now to reduce exposure to higher taxes in future years is "a great move," Slott advised, especially if a taxpayer opens a Roth IRA.

"You will get better use out of the money," Slott said. "Instead of the money sitting there racking up taxes [in stocks or bonds], you can put it into a Roth IRA that benefits you during life and your heirs tax-free after your death."

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