High Earners Will Pay More Taxes In 2013

Combination of American Taxpayer Relief Act and Affordable Care Act Pushes Up Tax Rates for High Earners

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Certain high earners will face a double-barrel shot of higher federal income taxes for 2013. The American Taxpayer Relief Act of 2012 (ATRA 2012) increased the tax rate for certain high earners from a maximum of 35 percent in 2013 up to a maximum of 39.6 percent in 2013.

In addition, provisions of the Affordable Care Act of 2010 (ACA) finally go into effect in 2013. For certain high earners, ACA provides for an additional 3.8 percent health care surtax on passive investment income under IRC Section 1411.

ATRA 2012 and ACA each have a different definition of who is classified as a *high earner* and who will be subject to the increase in tax rates.

Let's take a look at the basic provisions of ATRA and ACA individually and then we'll take a look at the combined tax effect for those who will get the double-barrel tax hit.

American Taxpayer Relief Act of 2012

Here is a summary of who will pay higher income taxes in 2013 based on ATRA 2012:

- For married couples with total taxable income (below the line *after* itemized deductions) greater than $450,000 and single individuals with taxable income greater than $400,000, the top marginal tax rate will be 39.6 percent. This is up from a 35 percent maximum rate in 2012.
- These tax brackets are indexed for inflation just as the income tax rates have been indexed since the early 1980s.
- For married couples with total taxable income greater than $450,000 and single individuals with taxable income greater than $400,000, long term capital gain income and qualified dividend income will be taxed at a rate of 20 percent. This is up from a 15 percent maximum rate in 2012.

Affordable Care Act of 2010

Here is a summary of who will pay the health care surtax in 2013 based on ACA.

- For married couples with modified adjusted gross income (above the line *before* itemized deductions) in excess of $250,000 and single individuals with modified adjusted gross incomes in excess of $200,000, there will be an additional 3.8 percent health care surtax on passive investment income.
- These $250,000 and $200,000 thresholds are not indexed for inflation.
- Passive income is defined as interest, rents, royalties and taxable annuity amounts and is taxed at ordinary income rates as high as 39.6 percent.
- Passive income is also defined as long term capital gains and qualified dividends, taxed at the capital gain/dividend rates of 15 or 20 percent.

Combined Effect of ATRA 2012 and ACA

Chart 1 illustrates a summary of the combined effect in 2013 for those who will be subject to the increased tax rates of both ATRA 2012 and ACA. Note the threshold differences between ATRA 2012 and ACA. The $450,000/$400,000 threshold (indexed) of ATRA 2012 is based on excess *taxable income* above the threshold. The $250,000/$200,000 threshold (not indexed) of the ACA is based on excess *modified adjusted gross income* (MAGI) above the threshold.

Combined Effect of ATRA 2012 and ACA	Top Tax Rate		Health Care Tax		Top Total Rate
Earned Income, Interest, Rents, Royalties, Taxable Annuity Amounts (Ordinary Income)	39.6%	+	3.8%	=	43.4%
Long Term Capital Gain and Qualified Dividends — MAGI Married $250,000 / Single $200,000	15.0%	+	3.8%	=	18.8%
Long Term Capital Gain and Qualified Dividends — Taxable Income Married $450,000 / Single $400,000	20.0%	+	3.8%	=	23.8%

Additional Important Notes Regarding Passive Investment Income

• Passive investment income under ACA is defined specifically as the lesser of net investment income or the excess of MAGI over the threshold amount (i.e., $250,000 married and $200,000 single).

• Some common types of income *are not* considered passive investment income. This includes wages, salaries and bonuses (i.e., earned income); Social Security benefits; tax exempt interest; excluded gain on the sale of a personal residence; distributions from any type of a qualified retirement plan or IRA; and tax-free Roth IRA distributions.

• Taxable distributions from qualified plans and IRAs and taxable amounts from IRA conversions to Roth IRAs will increase MAGI and could trigger the 3.8 percent tax for those with total income over the threshold amounts.

Example 1: 3.8 percent health care tax (investment income greater than excess MAGI over threshold).

Assume married taxpayers have a MAGI of $300,000 which includes passive investment income of $100,000. Since they are over the threshold of $250,000, they are subject to the additional 3.8 percent surtax.

• The excess of $300,000 MAGI over the $250,000 threshold equals $50,000.

• The surtax applies to the lesser of the excess MAGI over the threshold ($50,000) or the amount of net passive investment income ($100,000).

• Thus the extra tax would be 3.8 percent of $50,000, or $1,900.

Example 2: 3.8 percent health care tax (investment income less than excess MAGI over threshold).

Assume these same married taxpayers have a MAGI of $400,000 which includes passive investment income of $100,000. Since they are over the threshold of $250,000, they are subject to the additional 3.8 percent surtax.

• The excess of $400,000 MAGI over the $250,000 threshold equals $150,000.

• The surtax applies to the lesser of the excess MAGI over the threshold ($150,000) or the amount of the net passive investment income ($100,000).

• Thus, the extra tax will be 3.8 percent of $100,000, or $3,800.

The Effect of Higher Combined Tax Rates on Choice of Financial Assets

As a result of combined tax rates edging higher under current law (add state income taxes to combined federal rates), clients will consider certain types of financial assets more favorably. For example, tax-deferred and tax-free financial assets will become more attractive as the combined income tax rate on other alternative financial assets becomes higher. In 2013 the combined federal and state marginal tax rates for certain high earners can approach or exceed 50 percent.

The tax-favored financial products that might become even more attractive as combined income tax rates rise will generally fall into these categories:

• Non-qualified fixed and indexed annuity products where the account value gain is tax deferred and withdrawals are taxed under the last-in-first-out (LIFO) method of taxation.

• Non-MEC cash accumulation universal, indexed or whole life insurance where the cash value gain is tax deferred, withdrawals to basis are first-in-first-out (FIFO) and loans and death benefits are tax free.

• Qualified retirement plans such as 401(k)s, 403(b)s, 457(b)s, IRAs, SEP plans, profit sharing plans and defined benefit plans where tax deductions and elective deferral contributions can be maximized.

• "Standalone" long term care policies where the premium is either fully deductible or partially deductible to C corporations, S corporations and LLC business owners, and where any long term care benefit claim payments are tax free.

Technical Note: At this time, it is unclear whether any ordinary income taxation on life insurance policies will be considered passive investment income and subject to the 3.8 percent surtax. IRC Section 1411(c) does not specifically mention life insurance under the definition of net investment income. However, a liberal reading of the wording of IRC Section 1411(c)(1)(A)(iii) ("net gain attributable to the disposition of property") could bring any income taxation of certain life insurance transactions under the definition of net investment income for purposes of the 3.8 percent surtax. Life insurance would seem to be a form of "property" that could incur a "net gain" under certain circumstances:

- Surrender of a policy in a gain position.
- Elimination and discharge of a policy loan in the process of a Section 1035 exchange.
- Lapse of a heavily loaned policy in a gain position.
- Withdrawals in excess of cost basis.
- LIFO withdrawals/loans from a modified endowment contract (MEC) in a gain position.
- "Force-outs" in the first 15 years from a policy under the IRC Section 7702(f)(7) definition of life insurance.
- Sale of a policy in a gain position to a life settlement company.

All of these taxable transactions will generate a Form 1099R from the insurance carrier to the policyowner with a copy to the IRS.