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Taxes—Paying for Healthcare

The Health Care and Education Affordability Reconciliation Act of 2010 (the "Act"), signed by President Obama on March 30, 2010, guarantees coverage to many who are currently uninsured and expands coverage to those to whom it might have otherwise have been denied due to pre-existing conditions or the onset of illness at the time when the coverage is most needed.

Unfortunately, such benefits come with a price and the price will be paid in large part by additional taxes, an estimated $438 billion, imposed on high-income earners over the coming decade. To make matters worse, the impact of these additional taxes is exacerbated by the expiration of the Bush tax cuts of 2001 and 2003, which are sunset at the end of this year unless a contentious Congress enacts legislation to the contrary.

It's always worth remembering, however, that any change is a good reason to contact clients, revisit their situations, and discuss how the new legislation is likely to affect them. Below is a brief summary along with key talking points.

Increased Medicare Taxes

A major component of the new healthcare law is increased Medicare taxes. Beginning in 2013 there is an additional 0.9% Medicare tax on wages and self-employment income in excess of $200,000 ($250,000 for joint filers). Currently the Medicare portion of FICA taxes is at 2.9% with 1.45% paid by the employer and 1.45% paid by the employee. The increase would fall solely on the employee, although employers are expected to have additional withholding requirements.

In addition to increasing Medicare taxes on wages and self-employment income, the new law also imposes Medicare taxes on "net investment income." This is a major tax policy shift. Until now, only wages and self-employment income had been subject to Medicare taxes.

Beginning in 2013, a tax of 3.8% will be imposed on the lesser of (1) annual net investment income or (2) the excess of modified adjusted gross income (AGI) over the threshold amount ($250,000 in the case of a joint return, or $200,000 in the case of a single return).

For this purpose, net investment income includes the following:

- Gross income from interest, dividends, royalties, and rents;
- Net gains from the disposition of property, such as the sale of stocks, bonds, and real estate;
- Gross income derived from a business constituting a passive activity to the taxpayer (including operating income and gain on sale of an operating business that flows up to the taxpayer-investor in a fund that is taxed as a partnership for income tax purposes); and
- Gross income derived from a trade or business comprised of trading in financial instruments or commodities (whether or not the taxpayer is active in the business).

Consider the following examples:

Example 1
In 2013, Jake Mansfield (married filing jointly) generates $275,000 of net investment income. Jake also has $500,000 of W-2 income. The total Medicare tax is $10, 450, calculated by multiplying 3.8% by $275,000. This is the lesser of (1) $275,000 (net investment income) and (2) $775,000 (modified AGI) minus $250,000 (threshold amount).

Example 2
In 2013, Beth Carter (married filing jointly) earns $255,000 of net investment income. Beth also has $125,000 of W-2 income. The total Medicare tax is $4,940, calculated by multiplying 3.8% by $275,000. This is the lesser of (1) $255,000 (net investment income) and (2) $380,000 (modified AGI) minus $250,000 (threshold amount).

The new Medicare tax on investment income could be worse than appears on the surface. Currently dividends are taxed at only 15%, but are set to be taxed at regular income tax rates after this year. Unless Congress enacts other legislation, the maximum income tax rate, which would apply to most high-net worth clients, will increase from 35% to 39.6%. When the new Medicare tax is added to the regular income tax, the marginal rate on dividends could go as high as 43.4%, beginning in 2013. Fortunately, the Obama Administration has proposed a cap on dividends of 20%, but it remains in doubt whether Congress will be able to agree on much of anything this year.

Furthermore, the current 15% rate on capital gains reverts to 20% after 2010. When the new Medicare tax on investment income is added in 2013, capital gains could be taxed at 23.8%.

Talking Points

In light of the fact that the new legislation doesn't take effect until 2013, wealth managers should use the time between now and then to reposition portfolios and prepare clients for the increased tax bite.

Unless Congress enacts other legislation, the maximum income tax rate, which would apply to most of your clients, will increase from 35% to 39.6%. When the new Medicare tax is added to the regular income tax, the marginal rate on dividends could go as high as 43.4%, beginning in 2013.

- Clients with appreciated stocks may wish to sell in 2010 in order to take advantage of the currently low 15% capital gains tax rate.
- Clients who own residences, the sale of which would generate gain in excess of the current exclusions ($500,000 for married couples and $250,000 for individuals), should consider selling before rates go up.
- Clients receiving significant amounts of dividend income should consider repositioning to stocks with lower dividends and greater capital appreciation potential.

Also, keep in mind that "carried interest" from the sale of underlying investments, typically allocable to fund managers or developers, which is currently taxed at the favorable capital gains rate, becomes subject to the 3.8% Medicare tax beginning in 2013. Also, U.S. investors in and managers of hedge funds in which active trading of financial instruments or commodities is conducted will be subject to the 3.8% tax hike. On the other hand, note that the new tax does not apply to investment income from, or gain on the sale of, a business in which the taxpayer is an active participant. The Medicare tax also does not apply to nonresident aliens, trusts that are exempt under Code section 501, and certain other charitable trusts. Moreover, the Medicare tax does not apply to distributions from qualified retirement plans or interest on tax-exempt bonds.

Bottom Line

Don't allow your clients to be blindsided by increased taxes. Keep them informed, discuss repositioning, and earn their continued loyalty by being ahead of the curve.

Taxes and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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