

Wealth Strategy Report

The 3.8% Medicare Surtax on Investment Income

OVERVIEW

Beginning in 2013, certain investment income will be subject to an additional 3.8% surtax, enacted as part of the Health Care and Education Reconciliation Act of 2010. This tax will also have to be taken into account for estimated tax purposes. This is sometimes referred to as the “Medicare” surtax because the legislation enacting this tax created a new section of the tax code entitled: “Chapter 2A – Unearned Income Medicare Contribution.” However, this was simply a revenue-raiser enacted to offset the cost of health care legislation; there does not appear to be any reason this surtax must be used for Medicare.

This summary describes this coming tax, how it is calculated, and some planning issues and opportunities. However, there has been no guidance issued by the IRS, and some of the issues discussed below might not be addressed before the tax comes into effect in 2013.

INTRODUCTION

For an individual¹, the 3.8% surtax is imposed on the lesser of:

- (i) “net investment income” (NII), or
- (ii) the excess of “modified adjusted gross income”² (MAGI) over a certain threshold amount.

For trusts and estates, the 3.8% surtax is imposed on the lesser of:

- (i) undistributed NII, or
- (ii) the excess of adjusted gross income over a threshold that in 2013 will be about \$12,000.³

Tax exempt entities, such as charities, charitable remainder trusts, traditional IRAs and Roth IRAs will not be subject to the 3.8% surtax. While IRA distributions will not be considered NII (as discussed

below), distributions from a charitable remainder trust could be NII to the recipient/beneficiary.

WHAT IS “NET INVESTMENT INCOME”?

NII is defined to consist of three categories of gross income. For each category the gross amounts are allowed to be reduced by “the deductions . . . properly allocable to such gross income or net gain.”

Category #1: Gross income from interest, dividends, annuities, royalties and rents. This would exclude tax-exempt municipal bond interest.

It would not matter that these types of income are from your investment in a partnership or S corporation. For income tax purposes, the character of the income of a partnership or S corporation “flows through” and retains its character. For example, interest or dividends recognized by a partnership or S corporation would constitute interest or dividends to the partner/shareholder for purposes of this 3.8% surtax.

An individual’s income of this type generated in a trade or business is not subject to the tax, unless it would fall within Category #2 below. However, an individual’s income of this type generated in a trade or business from the investment of working capital would indeed be subject to this tax.

¹ This tax does not apply to nonresident aliens.

² “Modified adjusted gross income” is adjusted gross income increased by the net amount of foreign-sourced income that was exempt for regular tax purposes under Section 911(a)(1).

³ The threshold is the dollar amount at which the highest tax bracket is reached for trusts and estates. For 2012 that amount is \$11,650. It is indexed for inflation; in 2013 it will be approximately \$12,000.

Category #2: Gross income from (1) a passive activity, or (2) a trade or business of trading in financial instruments or commodities. A “passive activity” is defined to be a trade or business in which you do not “materially” participate.

This category would include net business income from Master Limited Partnerships (MLPs) that operate as Limited Liability Companies (LLCs) and are taxed as partnerships. The income of such MLPs is business income, and because of the LLC structure, that income flows through to passive investors as passive income. Often, however, MLPs have deductions that offset much of the business income.

This category would also include business income from closely-held family businesses operating in LLC or S corporation form, where some family members own units/shares but are not actively involved in the business (i.e., they are “passive” under the tax rules). The business income that flows through to the non-involved family members would be passive income and therefore would be NII.

Rental income. The statute includes in NII rents “other than such income which is derived in the ordinary course of a [non-passive] trade or business.” As a result, rental income from a passive activity would be included in your NII; rental income from a trade or business that is not a passive activity would not.

Category #3: Net gain “to the extent taken into account in computing taxable income.” This would include capital gain. The use of the term “net gain” would seem to imply that capital losses incurred in the current year would be taken into account to determine the net gain. It is not clear from the statute whether capital losses that have carried forward from previous years for regular income tax purposes would be allowed for purposes of calculating “net gain” subject to the 3.8% surtax.⁴ Hopefully this will be clarified.

Net gain is subject to the 3.8% surtax “to the extent taken into account in computing taxable income.” Gain excluded from income for regular tax purposes would therefore not be subject to the 3.8% surtax. This would exclude gains such as the following, all of which are excluded from taxable income:

- gain on the sale of a principal residence that is excluded from income under Section 121 (up to \$250,000; \$500,000 for a married couple);
- gain on the sale of Qualified Small Business Stock that is excluded from income;
- gain on tax-free like-kind exchanges;
- gain on the sale of stock to an ESOP that is excluded from income due to the purchase of “qualified replacement property”;
- gain on the tax-free exchange of insurance policies;
- the internal “build up” of value inside a life insurance policy.

“Net gain” is defined to be net gain “attributable to the disposition of property other than property held in a [non-passive] trade or business.” In other words, gain on the sale of business assets would not be subject to the 3.8% surtax.

It would seem the term “net gain” could also be broad enough to include “recapture” income that is often recognized on the sale of investment real estate.

SPECIAL RULES

Disposition of S corporation stock or partnership interests. In the case of the sale of an interest in an S corporation or an interest in a partnership, there is a special rule. The 3.8% surtax is imposed only on a portion of that gain – the transferor’s gain that would be subject to the 3.8% surtax as Category 3 “net gain” if the entity (the S corporation or partnership) had sold all of its property for fair market value “immediately before” the stock or partnership interest was sold.

This is intended to be a pro-taxpayer provision, shielding from the 3.8% surtax net gain attributable to an active trade or business.⁵

Example. You are a 50% partner in an active business. You sell your 50% partnership interest for a gain, which would be subject to the 3.8% surtax. Assume that if the partnership sold all of its assets, because you are active in the business, that would be the sale of business assets that, as mentioned above, is not subject to the 3.8% surtax, and your share of that would be 50%. Because none of your

⁴ The statute subjects to tax the net investment income “for such taxable year.” It is unclear whether this might also limit capital losses (for purposes of the 3.8% surtax) to those incurred in the current taxable year.

⁵ This particular provision is labeled in the tax law: “exception for certain active interests in partnerships and S corporations” [emphasis added].

share of the gain from a hypothetical sale would be subject to the 3.8% surtax, none of your gain on the sale of your partnership interest would be subject to the 3.8% surtax.

Exception for retirement plan distributions. The statute expressly states that distributions from the following retirement plans are not NII:

- qualified pension, profit-sharing, and stock bonus plans;
- qualified annuity plans;
- annuities for employees of tax-exempt organizations or public schools;
- IRAs;
- Roth IRAs;
- deferred compensation plans of state and local governments and tax-exempt organizations.

By singling out these retirement plan distributions, the statute raises an issue. Namely, it does not appear that any of the retirement plan distributions listed above would fit into any of the three categories of NII discussed above. So why expressly exclude these distributions from NII if they would not have been included in the first place? Is the negative implication that other distributions from nonqualified deferred compensation plans are indeed included in NII? Hopefully this will be clarified.

WHAT IS NOT INCLUDED IN NII?

Any income not within the definition of NII would not be subject to this tax. This would include the following:

- wages, salary and other compensation income;
- income on the exercise of compensatory options;
- income on the vesting of restricted stock;
- qualified retirement plan distributions, as mentioned above.

All of these, however, would still be included in MAGI. The 3.8% surtax is imposed on the lesser of (i) NII, or (ii) the excess of MAGI over a certain threshold amount. Therefore, although these items of income listed above are not included in NII, they could nevertheless affect your exposure to this tax.

Example. You are single, which means your threshold for purposes of the surtax is \$200,000.

You have NII of \$40,000 and other income of \$160,000, so your MAGI is \$200,000. Because your MAGI does not exceed your threshold, the surtax does not apply. However, assume you then exercise compensatory stock options and recognize an additional \$50,000 of income. Although this \$50,000 of income is not NII, it causes your MAGI to increase to \$250,000, which exceeds your threshold by \$50,000. As a result, your \$40,000 of NII is now subject to the 3.8% surtax.

Incentive Stock Options (ISOs). Generally, the exercise of an ISO is not subject to regular income taxation (though it is taxed as compensation for purposes of the alternative minimum tax). If the stock is later sold, it would generate capital gain. Historically, this has been a beneficial treatment: not being taxed as compensation income when exercised, but being taxed as capital gain later when the stock is sold. Now, however, if the stock is later sold, that capital gain could be subject to the additional 3.8% surtax, although this will still likely be a lower rate than the rate applicable to compensation income.

WHAT ARE THE THRESHOLDS?

The threshold amount (“Threshold”) for a tax year depends on your filing status, as set forth in the chart below.

| Filing Status | Threshold |
|---|-----------|
| Married filing jointly, or Qualifying Widow[er] | \$250,000 |
| Single, Head of Household | \$200,000 |
| Married filing separately | \$125,000 |

THE SURTAX IS IN ADDITION TO THE ALTERNATIVE MINIMUM TAX

The new statute states that the 3.8% surtax is to apply “in addition to any other tax imposed by this subtitle.” “This subtitle” refers to the part of the tax law that contains both the regular income tax and the alternative minimum tax. Therefore, the 3.8% surtax is in addition to your regular income tax, and it is in addition to any alternative minimum tax.

PLANNING OPPORTUNITIES FOR INDIVIDUALS IN 2012 – ACCELERATING GAIN INTO 2012

The maximum long-term capital gain rate in 2012 is 15%; it is currently scheduled to increase to 20% in 2013. The 3.8% surtax would make the 2013 maximum rate imposed on capital gain 23.8%. In some cases it could make sense to accelerate gain into 2012 in order to incur the lower rate. One important factor in such a choice is how far into the future the 23.8% tax would otherwise be incurred. For example, if you were planning to sell stock in 2013 in any event, then it might make sense to incur a 15% capital gain rate in 2012 rather than a 23.8% capital gain rate in 2013. In contrast, if you were not planning to sell the stock in the near future, then incurring a 15% capital gain rate in 2012 rather than a 23.8% capital gain rate many years in the future might not make sense.

PLANNING OPPORTUNITIES FOR INDIVIDUALS IN 2013

The tax is imposed on the lesser of two related amounts: (i) NII and (ii) the excess of MAGI over the Threshold. These two numbers are related; MAGI will consist of NII plus all other income that is not NII (“Other Income”). So, an additional dollar of NII will increase both NII and MAGI. In contrast, an additional dollar of Other Income, such as salary, will increase only MAGI but not NII. This interplay can lead to some planning opportunities if one of the following describes your tax situation for the year:

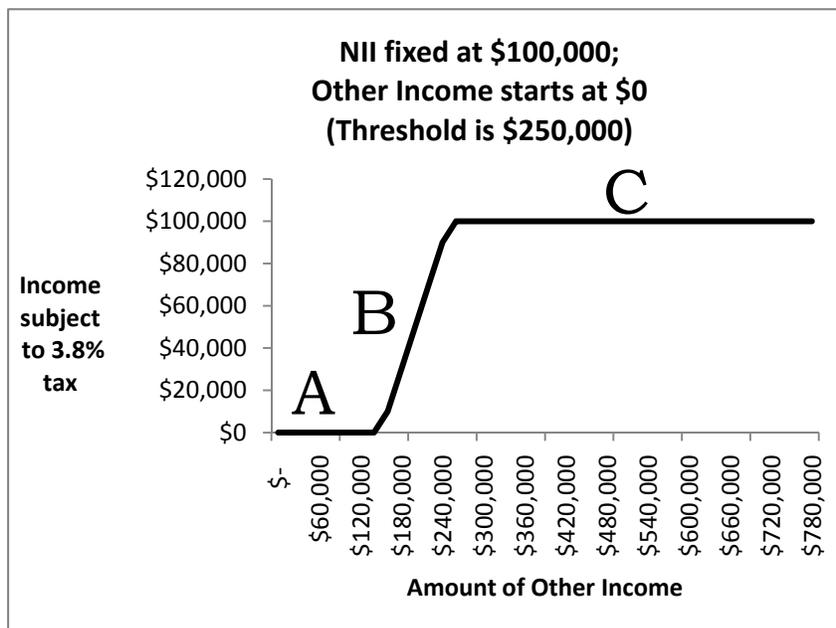
1. Your NII is fairly fixed; you can control your Other Income
2. Your Other Income is fairly fixed; you can control your NII

Your NII is fixed; you can control Other Income

Here we are assuming that your expected NII is fairly fixed, and your Other Income is more controllable. To illustrate the planning in this case, we will use an example. Assume that for the tax year, you expect

your NII to be fixed at \$100,000, and your Threshold is \$250,000 (i.e., you file a joint return). The chart below shows that as Other Income increases, the amount exposed to the 3.8% surtax increases. There are 3 parts of the solid line in this chart, labeled “A”, “B” and “C”. These correspond to 3 possible planning opportunities, depending on which section applies to your situation.

Section A. There is an amount of Other Income you can recognize without triggering the 3.8% surtax. In the chart, you will see that for Other Income between \$0 and \$150,000, nothing is exposed to the 3.8% surtax. That is because for that range of Other Income, when added to the assumed \$100,000 of NII, the total MAGI will still not exceed the \$250,000 Threshold. That is,



there will be no excess of MAGI over Threshold. Because the 3.8% surtax is imposed on the lesser of NII or such excess over the Threshold, the tax will be \$0. The tax will first apply only when there is an excess of MAGI over the Threshold, which in this example (NII of \$100,000 and Threshold of \$250,000) will first occur when Other Income exceeds \$150,000.

The amount of Other Income that can be recognized without triggering the 3.8% surtax is your Threshold minus your NII, as set forth in the following Table.

| NII | This much Other Income can be recognized without triggering the 3.8% surtax. (The formula is Threshold - NII) | | |
|-----------|---|---------------------|---------------------|
| | \$250,000 Threshold | \$200,000 Threshold | \$125,000 Threshold |
| \$50,000 | \$200,000 | \$150,000 | \$ 75,000 |
| \$75,000 | \$175,000 | \$125,000 | \$ 50,000 |
| \$100,000 | \$150,000 | \$100,000 | \$ 25,000 |
| \$125,000 | \$125,000 | \$75,000 | |
| \$150,000 | \$100,000 | \$50,000 | |
| \$175,000 | \$75,000 | \$25,000 | |
| \$200,000 | \$50,000 | | |
| \$225,000 | \$25,000 | | |

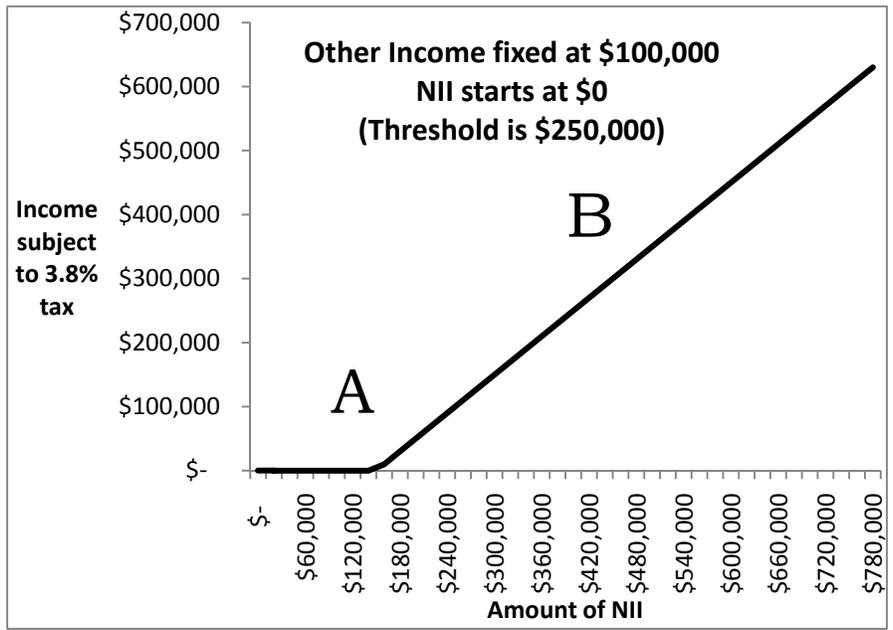
Section B. Once you have sufficient Other Income, you will begin incurring the 3.8% surtax. As your MAGI increases, so does the amount of income exposed to the 3.8% surtax. In that case, the straightforward planning would be to minimize your MAGI, which is discussed below.

Section C. There is a point where your exposure to the 3.8% surtax hits a maximum and thereafter will not increase. In this example we are assuming NII is fixed at \$100,000 and only Other Income is increasing. At some point, when there is sufficient Other Income, the excess of MAGI over Threshold will exceed the NII of \$100,000. From that point on, the NII of \$100,000 will be the lesser of the two, which means the tax will not increase no matter how much more Other Income is recognized. This maximum exposure to the 3.8% surtax will occur when the amount of Other Income equals the Threshold.

This is not a true planning opportunity. Rather, it's useful to know when your exposure to the 3.8% surtax has maxed out and additional Other Income will not generate additional exposure. For example, consider a married couple with both (i) NII that is fixed for the year, and (ii) combined wages and bonus of more than \$250,000. Given those facts, the NII is already fully exposed to the 3.8%; there would be no need to worry that additional Other Income might increase exposure to the 3.8% surtax.

Your Other Income is fixed; you can control NII

Here we are assuming that your expected Other Income is fairly fixed, and it is NII that is more controllable. Assume that for the tax year you expect your Other Income to be fixed at \$100,000, and your Threshold is \$250,000. The following chart shows that



as NII increases, the amount exposed to the 3.8% surtax increases.

This chart is very different from the prior chart. There are 2 sections of the solid line in this chart, labeled "A" and "B". These correspond to 2 possible planning opportunities, depending on which section applies to your situation.

Section A. There is an amount of NII you can recognize without triggering the 3.8% surtax. In the chart, note that for NII between \$0 and \$150,000, nothing is exposed to the 3.8% surtax. That is because for that range of NII, when added to the assumed \$100,000 of Other Income, the total MAGI will still not

exceed the \$250,000 Threshold. That is, there will be no excess of MAGI over Threshold. Because the tax is imposed on the lesser of NII or any such excess, the tax will be \$0. The tax will first apply only when there is an excess of MAGI over the Threshold, which in this example (Other Income of \$100,000 and Threshold of \$250,000) will first occur when NII exceeds \$150,000.

This is the same dynamic as in the previous chart, but here we have changed which element is fixed (here it is Other Income) and which is variable (here it is NII). The amount of NII that can be recognized without triggering the 3.8% surtax is your Threshold minus your Other Income, as set forth in the following Table

| | This much NII can be recognized without triggering the 3.8% surtax. (The formula is Threshold - Other Income) | | |
|--------------|--|---------------------|---------------------|
| Other Income | \$250,000 Threshold | \$200,000 Threshold | \$125,000 Threshold |
| \$50,000 | \$200,000 | \$150,000 | \$ 75,000 |
| \$75,000 | \$175,000 | \$125,000 | \$ 50,000 |
| \$100,000 | \$150,000 | \$100,000 | \$ 25,000 |
| \$125,000 | \$125,000 | \$75,000 | |
| \$150,000 | \$100,000 | \$50,000 | |
| \$175,000 | \$75,000 | \$25,000 | |
| \$200,000 | \$50,000 | | |
| \$225,000 | \$25,000 | | |

Section B. Once the tax applies (when enough NII has been recognized to cause MAGI to exceed the Threshold), the dynamics here are very different than in the prior example. Here, every additional dollar of NII will increase both NII and MAGI. As a result, the amount of income exposed to the 3.8% surtax does not hit a maximum, as in the first chart. Rather, as NII increases, the amount of income exposed to the tax increases, without a limit. In this case, the straightforward planning would be to minimize your NII, which is discussed below.

MINIMIZING NII

The first step should be to confirm that there's any benefit to minimizing NII. As shown in the examples above, it could be the case that recognizing additional NII would not expose you to the 3.8% surtax; it might not be an issue. If it is, here are some planning considerations.

Tax Exempt Bonds. Investing in tax-exempt bonds might result in less exposure to the 3.8% tax than investing in taxable bonds. That will depend on a comparison of the after-tax yields of both. The after-tax yields of taxable bonds will now be affected by this 3.8% surtax. If the after-tax yield of a tax-exempt municipal bond and the after-tax yield of a taxable bond are the same after factoring in the 3.8% surtax, then you would be indifferent for tax purpose as to which type of bond you owned.

Minimize dividends. Dividend-paying stocks will now be taxed more heavily. This could encourage a preference for investments that pay little/no dividends and instead generate capital appreciation. This could include non-dividend or low-dividend stocks and, in general, non-principal protected structured notes. While the resulting capital gain from these investments would also be included in NII, there would be two potential benefits: (i) because the capital gain would be exposed to the 3.8% tax only when the stock is sold, that tax would be deferred until then; and (ii) capital gains can be offset by capital losses whereas dividends cannot.⁶

Increase participation to make passive income non-passive. Income from a passive activity will be subject

to the 3.8% surtax. If your level of activity could be increased so that the business income becomes non-passive, that could avoid the tax.

Review how your passive activities are aggregated. In determining whether you are active or passive in an "activity," there are rules governing what constitutes an "activity" and how different activities might be aggregated and considered one single "activity." You should consult with your tax advisor to see whether you might be able to determine your "activities" in a way that might minimize your passive income.

Convert passive income to salary. Income from a trade or business that is a passive activity will be taxed as ordinary income and will also be subject to the 3.8% surtax. If some of that income could instead be paid as compensation, that would also be taxed as ordinary income but would avoid the 3.8% surtax. However, it would also expose that income to payroll taxes (including the additional 0.9% payroll tax that is scheduled to begin in 2013), which could result in even heavier taxation.

Capital Loss Harvesting. Harvesting capital losses is a common annual year-end tax planning idea that could now be even more important. Similarly, certain investment programs that emphasize harvesting capital losses on a regular basis throughout the year could now be more appealing. One example of such a program is U.S. Trust's Tax Efficient Structured Equity (TESE) Program.

Installment Sales. An installment sale is a sale where some of the payments are to be received in a future year. In that case, if certain conditions are met, you can report any resulting capital gain ratably as the payments are received, rather than reporting all of the gain in the year of sale. If the capital gain involved is NII, then spreading it out over multiple years might cause the 3.8% surtax to be less than if all of the capital gain were included in NII in the year of sale.

MINIMIZING MAGI

If you can minimize MAGI, then that would minimize the excess of MAGI over Threshold, which could minimize the 3.8% surtax. Again, however, you should confirm that there's any benefit to minimizing MAGI. As discussed above, it could be the case that recognizing additional income would not expose you to additional 3.8% surtax. If it would, here are some planning considerations.

⁶ After capital losses are used to offset capital gains, another \$3,000 of capital losses can be used to offset other income, for regular tax purposes. For purposes of the 3.8% surtax, however, it appears this \$3,000 loss could not offset dividend income.

Income in AGI. There are several opportunities to reduce AGI (and therefore MAGI), which can be seen by looking at the front page of Form 1040. The planning here is not to reduce NII; the income described below is not NII. Rather, it is the second part of the calculation – the excess of MAGI over the Threshold – that is being planned for here. Also, none of these income-reducing ideas is new. For example, presumably you were motivated to minimize Schedule C income even before implementation of the 3.8% surtax.

- Schedule C income – Sole proprietor. Any expenses that would reduce the net business income on Schedule C will reduce AGI and possibly the amount of income exposed to the 3.8% surtax.
- Schedule D - Capital gains. Harvesting losses would now save 23.8% (assuming the rate applicable to long-term capital gain is 20% in 2013). Similarly, certain investment programs that emphasize harvesting capital losses on a regular basis throughout the year (such as U.S. Trust's TESE Program) could now be more appealing.
- IRA distributions. Distributions from an IRA are not NII. However, if an IRA distribution is taxable, that will increase AGI, which could have the result of exposing NII to the 3.8% surtax. Therefore, minimizing the income from IRA distributions could minimize the 3.8% surtax. That could include the following planning considerations:
 - The Charitable IRA Rollover provision. This provision allows for distributions directly from your IRA to certain charities.⁷ As of the date this summary was written (February 2012), this provision has not been extended beyond 2011. If it is extended, then using that provision would cause you to have less income in your AGI, which could decrease your exposure to the 3.8% surtax.
 - Roth Conversion.⁸ If your traditional IRA is converted to a Roth IRA, then future distributions that are “qualified distributions” would be tax-free and therefore would not increase your AGI or otherwise affect your

exposure to the 3.8% surtax. This could be another factor in favor of a Roth conversion. Note, however, that a Roth conversion itself would cause you to recognize income, which would increase your AGI, which could affect your exposure to the 3.8% surtax in the year of conversion. Converting to a Roth before 2013 would avoid that result, since the 3.8% surtax does not apply until then.

- Schedule E – Income from rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc. Any expenses that would reduce the net business income on Schedule E will reduce AGI and possibly the amount of income exposed to the 3.8% surtax.
- Schedule F – Farming. Any expenses that would reduce the net business income on Schedule F will reduce AGI and possibly the amount of income exposed to the 3.8% surtax.

Above the line deductions. The following deductions are allowed before determining AGI and therefore could reduce the income exposed to the 3.8% surtax:

- deductible contributions to a Health Savings Account;
- deductible contributions to self-employed retirement accounts;
- deductible contributions to a traditional IRA.

MAXIMIZING THE THRESHOLD

Presumably there is limited opportunity here. Nevertheless there are situations when there is a choice of filing status. In those cases, the filing status chosen would determine the Threshold, which could affect the impact of the 3.8% surtax.

THE ROLE OF ITEMIZED DEDUCTIONS

It is unclear the extent to which Itemized deductions will affect the calculation of the 3.8% surtax.

Itemized deductions are taken into account after the calculation of AGI and so do not affect MAGI. As a result, itemized deductions would seem not factor into planning for the 3.8% surtax. For example, charitable contributions are deductible as an itemized deduction. Therefore, increasing charitable contributions will have no effect on the amount of income exposed to the 3.8% surtax.

⁷ We have a separate Tax Alert: [Resuscitating the IRA Charitable Rollover.](#)

⁸ We have a separate summary on Roth conversions.

However, the statute defines NII to mean the three categories of investment income discussed above, reduced by “the deductions allowed by this subtitle which are properly allocable to such” investment income. Some itemized deductions, such as taxes and investment interest, would seem to be “properly allocable” to investment income. In that case, while those itemized deductions would not affect the calculation of MAGI, they might nevertheless reduce NII. Hopefully there will be guidance on how to determine what deductions are “properly allocable” to NII.

PLANNING FOR THE “KIDDIE TAX”

The so-called “kiddie tax” was enacted by Congress to prevent parents from transferring income-producing assets to their children in order to shift income from the parents’ higher tax bracket to the children’s lower tax bracket. If certain conditions are met, a part of your child’s unearned income can be taxed at your highest marginal tax rate.⁹

As part of planning for the kiddie tax, you can elect to include your child’s net unearned income on your income tax return as your own income. There are often reasons not to elect to do this; the 3.8% surtax may be another reason not to make this election. That is, if you include your child’s net unearned income on your income tax return as your own income, you might expose that income to your 3.8% surtax. The result could be a greater exposure to the 3.8% surtax than if your child’s net unearned income were taxed on your child’s own income tax return.

PLANNING FOR TRUSTS AND ESTATES

For trusts and estates, the 3.8% surtax is imposed on the lesser of (i) undistributed NII, or (ii) the excess of adjusted gross income over the dollar amount at which the highest trust/estate income tax bracket begins. For 2012, \$11,650 is the dollar amount at which the highest tax bracket is reached for trusts and estates. This amount is indexed for inflation and will be approximately \$12,000 for 2013. Though this is technically not referred to as a “threshold,” it operates in the same way, and so the second component of the tax (excess of AGI over the threshold) is similar to how the 3.8% surtax is imposed on individuals. With such a low threshold, the surtax could apply much more easily to trusts and estates.

There is one respect in which the surtax applies to trusts and estates very differently than it applies to individuals: the concept of “undistributed NII.”

Undistributed Net Investment Income. Trusts and estates are subject to a set of income tax rules whereby if the trust/estate earns income but distributes it to the beneficiaries, then the beneficiaries are taxed on that distributed income. If the trust/estate retains the income, then the trust/estate is taxed on that retained income. If the trust/estate distributes some of its income but also retains some, then the beneficiaries are taxed on the portion distributed, and the trust/estate is taxed on the portion retained. So, overall there is one tax; whether that one tax is imposed on the beneficiaries or the trust/estate (or some combination of both) depends on how much of the trust’s/estate’s income is distributed and how much is retained.

This “one or the other” approach will also apply to the 3.8% surtax. That is, to the extent a trust/estate distributes NII to the beneficiaries, that will be the beneficiaries’ NII for purposes of the 3.8% surtax. To the extent the trust/estate retains NII, that undistributed NII will be the trust’s/estate’s NII for purposes of the 3.8% surtax. This leads to the question of how the trust/estate is to determine whether NII has been retained or distributed.

The statute does not address this, but this type of issue is not new. There are many instances under current law where we need to know which of a trust’s/estate’s many types of income are to be considered to be the components of distributions to beneficiaries. For regular income tax purposes, the tax rules governing non-charitable trusts take a pro rata approach when determining how much of each category of income is retained in the trust and how much is distributed. While it is possible future regulations under the 3.8% surtax could take a different approach, it seems reasonable that the pro-rata rule that governs non-charitable trusts for regular income tax purposes would also govern for purposes of the 3.8% surtax.

Planning for trust distributions. Given the very low threshold for trusts and estates, one planning consideration is to distribute NII to the beneficiaries if their higher Thresholds would result in less tax. Of course, such distributions must be consistent with the terms of the trust and the trustee’s fiduciary duties.

⁹ We have a separate summary: *The “kiddie tax.”*

CONCLUSION

If you have any questions, we invite you to contact your U.S. Trust advisor.

— National Wealth Planning Strategies Group

Any examples are hypothetical and are for illustrative purposes only.

Note: This is not a solicitation, or an offer to buy or sell any security or investment product, nor does it consider individual investment objectives or financial situations.

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