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PAYROLL TAX ON INVESTMENTS.....?

By: Robert Klosterman, CEO & Chief Investment Officer

The current political season has accentuated the different stances on taxes from the candidates for the Presidency. The differences are very wide and have stark differences. The so called “Bush Tax Cuts” will expire at the end of 2012 and an additional Medicare tax will be imposed on the investment income and gains for taxable incomes above $200,000 single and $250,000 joint returns.

Assuming the tax cuts do expire, that would mean the Federal Long-Term Capital Gains Tax would rise from 15% to 20%, a 33% increase. Also assuming the Medicare 3.8% surtax on an income of more than $250,000 for a married couple filing jointly; this represents a 58% increase in the tax rate for this form of income. It doesn’t stop there as income from: interest, dividends, annuities, rents, royalties, income from passive activities, gains from securities and commodities trading, and gains from certain dispositions of business property are also included.

Items NOT included for the calculation include: retirement income from pensions, IRA distributions, social security, life insurance proceeds, municipal bond interest, and income from a business you materially participate in. While Pensions, IRA’s and company provided annuities are not included for the surtax they do count toward the income that will cause the tax. For example if $250,000 of income comes from Pensions and/or IRA distributions, all investment income would be subject to the Medicare tax on a joint return. If $50,000 comes from Pensions and IRA’s and $250,000 from interest, dividends and capital gains, then $50,000 is subject to the Medicare tax.

This Medicare tax can also apply to the sale of a personal residence. However, the calculation of the gain will be the sales price minus the cost basis minus the primary residence exclusion ($250,000 single-$500,000 joint) to figure the gain on a “primary” residence. Of course, no exclusion exists on secondary residences. Any gain over the $200,000 on a single return and $250,000 on a joint return would be subject to the Medicare tax.

Irrevocable Trusts and Estates do not benefit from the threshold of $200-250K of adjusted gross income. This tax can be applied with as little as $12,000 of taxable income. It also appears the children’s unearned income reported on a parent’s return will be affected by the tax.

Consideration of a Roth conversion to recognize the tax now for those retirement funds, and avoid the prospect of being included in income once the tax becomes effective in 2013 to avoid hitting the threshold limits of $200/$250K might be advisable. Municipal bonds as alternatives for fixed income could also be a consideration. If the current law expires the tax rate on qualified dividends, this could also materially change from 15% to, as high as, 39.6% having a significant impact on the after tax return.

Consideration to accelerate income into 2012 might be advisable as well. Careful review of all these options may lead to widely different conclusions based on individual circumstances.

2012 will be a year to consider how all these taxes may come into play for an individual. As taxpayers, we have faced the prospect of the Bush Tax Cuts expiring before, but in the end they have been extended. It remains to be seen if Constitutional challenges to the health care legislation will have any impact on the implementation of these provisions. Of course there also is the possibility of some to repeal the health care legislation could also come into play. Many believe taxes will go up, yet the political actions have delayed implementation (temporarily) and could continue. Clearly this being an election year the debates that will most likely happen will cause much confusion. I can only imagine the number of “head fakes” that will be delivered to add to the confusion of the situation. That being said, to not consider the options for planning a portfolio to allow the maximum flexibility to capitalize on opportunities that exist today may leave an investor with a feeling of frustration.

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