



## A CLOSER LOOK AT THE 3.8% SURTAX

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Grace Allison,  
Tax Strategist

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### BACKGROUND

*There is keen interest in the 3.8% surtax scheduled to become effective in 2013. As the analysis below indicates, this future tax affects a number of key decisions, ranging from Roth IRA conversion to asset allocation.*

To help finance the recent health care reform package, Congress has imposed a 3.8% surtax on the investment income of certain high-income taxpayers for taxable years beginning on and after January 1, 2013. For advisors to the affluent, the surtax will be an important factor in future planning.

### THE BASICS: APPLICATION TO INDIVIDUALS, TRUSTS, AND ESTATES

The coming surtax expressly applies not only to individuals, but also to trusts and estates. Here are the basics:

**Individuals.** For single individuals, the tax applies to net investment income to the extent modified adjusted gross income (“MAGI”) exceeds \$200,000; for marrieds filing jointly, the MAGI threshold is \$250,000.

*Example: In 2013, Harry is single, with MAGI of \$210,000. He has \$7,000 of net investment income. All of Harry’s net investment income (including net gain) would be subject to the surtax.*

**Trusts and estates.** For trusts and estates, the surtax will apply to the trust’s undistributed net investment income to the extent the trust’s adjusted gross income exceeds “the dollar amount at which the highest tax bracket in [IRC Section] 1(e) begins for the taxable year.”

**Practical pointer #1.** The income tax brackets for trusts and estates under IRC Section 1(e) are notoriously compressed, with the highest tax bracket beginning at \$11,200 in 2010. As a result, the surtax formula for trusts and estates may result in many estates and trusts being subject to the surtax.



Example: Assume that, in 2013, the highest tax bracket for trusts and estates begins at \$13,000. Assume Trust A is a simple trust with undistributed capital gains of \$263,000 and adjusted gross income of \$263,000. Here, adjusted gross income (\$263,000) exceeds the bracket amount (\$13,000) by \$250,000. \$250,000 of the trust's undistributed net investment income would be subject to the 3.8% surtax. (Note: The statute does not define "undistributed net investment income.")

## DEFINITIONS

As always, a clear understanding of key statutory terms is critical to effective tax planning. Below are some pointers relating to the not-so-intuitive definitions of "net investment income," "modified adjusted gross income," and "adjusted gross income."

**Definition of "net investment income."** "Net investment income" is defined broadly to include all forms of investment income, including net capital gains. Significantly, it also includes net income from "a trade or business of trading in financial instruments or commodities," language seemingly intended to reach certain income earned by hedge fund and commodity fund managers. The surtax also does not apply to income subject to self-employment tax.

Particularly for retirees, what isn't included in net investment income is as important as what is—distributions from IRAs or qualified retirement plans *are expressly not included* in "net investment income."

**Definition of "modified adjusted gross income."** "Modified adjusted gross income" is defined as adjusted gross income increased by certain amounts otherwise excluded from gross income under IRC Section 911(a).

**Practical pointer #2.** Because IRC Section 911(a) is a very narrow provision (it applies to citizens or residents of the U.S. who live abroad), for most of our clients "modified adjusted gross income" will be the same as adjusted gross income.

**Practical pointer #3.** Modified adjusted gross income does not include tax-exempt income. This will make tax-exempt bonds desirable from a tax standpoint at a time when the credit ratings for many municipalities may still be weak. It will be important for investors not to let the tax "tail" wag the investment "dog."

**Practical pointer #4.** MAGI includes distributions from retirement plans and accounts! Remember: the higher the MAGI, the more likely that net investment income will become subject to the surtax. This is another factor to take into account when considering whether to convert a traditional IRA to a Roth IRA.

*Example: In 2013, Harry has \$200,000 of net investment income and \$100,000 of income from a required minimum distribution from his traditional IRA. On these facts, Harry's total MAGI is \$300,000. As a result, \$100,000 (\$300,000 – \$200,000) of his net investment income would be subject to the surtax.*



*Note that if Harry had converted his traditional IRA to a Roth IRA back in 2010, his MAGI would be \$200,000 (no required minimum distribution!), and none of his net investment income for 2013 would be subject to the surtax.*

**Definition of “adjusted gross income.”** For purposes of computing the surtax for estates and trusts, “adjusted gross income” is defined in IRC Section 67(e). Treasury regulations reflecting the Supreme Court decision in *Knight* (limiting the deductibility of trustee fees) are likely to increase the adjusted gross income of trusts that previously claimed a deduction for fiduciary fees under IRC Section 67(e)(1).

For more information, contact Grace Allison at [ga3@ntrs.com](mailto:ga3@ntrs.com).

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