

The Surtax Cometh...

When President Obama and Congress enacted the Affordable Care Act, it included a federal surtax scheduled to arise on January 1, 2013. Taxpayers anxiously awaited a recent Supreme Court ruling before they considered much surtax planning. When the Supreme Court upheld this legislation in June, taxpayers and their advisers took notice to begin planning.

The surtax is designed to increase taxes on the investment income of "wealthy" taxpayers. This additional tax may coincide with higher dividend and capital gain tax rates if current laws sunset on December 31, 2012 as scheduled.

The following highlights some major points regarding the surtax under the Affordable Care Act.

The Basic "Tax-Speak"

The surtax (3.8% rate) will apply against all or part of the net investment income of taxpayers whose modified adjusted gross income ("MAGI") exceeds the threshold amount. The portion of net investment income subject to the surtax will depend on the amount by which MAGI exceeds the applicable threshold amount.

What Does That Mean?

The threshold amount equals (1) \$200,000 for single taxpayers, (2) \$250,000 for married taxpayers filing jointly, (3) \$125,000 for married taxpayers filing separately and (4) \$11,650 for estates and trusts.

So, if MAGI exceeds the threshold amount, the surtax will reach investment income. If MAGI does not exceed the threshold amount, no surtax would be applied to investment income.

For this purpose, MAGI equals the sum of adjusted gross income (Line 37 of IRS Form 1040, for example) plus the net foreign income exclusion amount.

Net investment income includes interest, dividends, capital gains (including the taxable portion of a home and private business sales), taxable annuity payments, rents, royalties and passive investment income. It does not include active business (self-employment) income or taxable retirement income (Social Security income or distributions from IRA's and qualified retirement accounts).

The portion of net investment income subject to the surtax will equal the lesser of (1) total net investment income or (2) the amount by which net investment income exceeds MAGI over the threshold amount.

For Example . . .

The following examples are designed to illustrate how the surtax may apply to a hypothetical taxpayer. They are not designed to replace the advice and counsel of your own tax adviser that would address your individual situation.

Example 1

- » If a married couple files a joint return;
- » Has wages of \$500,000; and
- » Has no investment income.

The surtax will not apply, because it applies only to net investment income (even though MAGI exceeds the threshold amount).

Example 2

- » If a married couple files a joint return;
- » Has no wages; and
- » Has investment income of \$300,000.

The surtax will apply to \$50,000 (the lesser of total net investment income (\$300,000) or the amount by which it exceeds the applicable threshold amount of \$250,000 (\$50,000)).

Example 3

- » If a married couple files a joint return;
- » Has wages of \$200,000; and

- » Has net investment income of \$200,000.

The surtax will apply to \$150,000 of net investment income (the lesser of (a) total net investment income (\$200,000) or (b) the amount by which the net investment income exceeds MAGI (\$400,000) over the threshold amount of \$250,000 (that is, \$400,000 minus \$250,000 equals \$150,000).

Example 4

- » If a married couple files a joint return;
- » Has wages of \$200,000; and
- » Has net investment income of \$49,000.

The surtax will not apply because MAGI does not exceed the applicable threshold amount.

Example 5

- » If a married couple files a joint return;
- » Has no wages;
- » Has investment income of \$250,000; and
- » Has received a required minimum distribution from a retirement account in the amount of \$100,000.

The surtax will apply to \$100,000 of net investment income (the lesser of (a) total net investment income (\$250,000) or (b) the amount by which the net investment income exceeds MAGI (\$350,000) over the threshold amount of \$250,000 (that is, \$350,000 minus \$250,000 equals \$100,000).

Note: This example highlights a common confusion regarding the surtax. Retirement distributions themselves are not subject to the tax. However, they are considered part of MAGI when

determining whether a taxpayer has net investment income that exceeds the applicable threshold amount.

Example 6

- » Assume someone is the sole beneficiary of his uncle's estate;
- » The estate has \$61,650 of net investment income; and
- » The estate made no distributions during the year.

The surtax will apply to \$50,000 of its net investment income (the amount by which it exceeds its threshold amount of \$11,650).

Example 7

Assume the same facts as Example 6, except that the executor distributed all net investment income from the uncle's estate to its beneficiary during the year.

The surtax would not apply to the estate because it had no retained net investment income. The surtax instead may apply to its beneficiary depending on his personal situation for the year (including his receipt of this distributed net investment income).

Example 8

- » If a married couple files a joint return;
- » Has wages of \$250,000; and
- » Has purchased a home for \$100,000 and sold it for \$1 million.

The surtax will apply to \$400,000 of net investment income. For this purpose, \$400,000 of the home sale is subject to capital gains tax (\$1 million sales price, less \$100,000 purchase price, less \$500,000 capital gains exclusion on home sale).

The \$400,000 of capital gain is included in net investment income. The surtax will apply to all of it because wages already place the taxpayers in this example at their threshold amount. So, all capital gain from home sale also would be subject to the surtax.

“The surtax will arrive next year...There is still time to plan ahead.”

Planning Ahead

When considering the challenge of the looming surtax, here are a few items to keep in mind:

A taxpayer's exemption amount(s) and itemized income tax deductions (such as medical expenses, mortgage interest and charitable contributions) do not lower MAGI and therefore cannot help avoid the surtax.

Retirement plan contributions, alimony and child support do lower MAGI and may affect whether the surtax applies.

Roth IRA conversions after this year will trigger ordinary income and increase MAGI. If MAGI exceeds the threshold amount in part because of the Roth IRA conversion, the surtax will apply to net investment income.

On the other hand, Roth IRA conversions completed before 2013 will not have the same effect. They still trigger current income tax; however, the surtax does not arise until 2013. In addition, distributions from a Roth IRA are not taxable and therefore will not increase MAGI.

Municipal bonds still are tax exempt and are not part of net investment income to which the surtax may apply.

Tax deferred annuities and life insurance contracts also may avoid being classified as part of net investment income.

Trusts and estates may pass income to beneficiaries through distributions to avoid the surtax.

Charitable trusts may be used as planning tools to shift income, to defer income recognition or to avoid the surtax altogether under certain circumstances.

Net investment income may be timed under certain circumstances by accelerating or deferring its recognition. If accelerated into 2012, the surtax could be avoided since it does not arise until 2013. By deferring in later years, the surtax may be deferred from a current year into the next one (or avoided if otherwise possible).

The Supreme Court's decision to uphold the Affordable Care Act and its related surtax will create more planning problems for taxpayers. There still is time to plan ahead.

ABOUT THE AUTHOR

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