tax IMPACT

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Get ready for new Medicare taxes

3 essential estate planning strategies not to be ignored

S corporation shareholder-employees: Are your salaries high enough?

Tax Tips
Retirement plan penalty exception, charitable trusts and more

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Get ready for new Medicare taxes

Beginning in 2013, higher-income taxpayers are scheduled to be subject to additional Medicare taxes, including a 3.8% tax on *investment* income. This is a dramatic departure from current Medicare taxes, which are limited to wages and self-employment income.

Even though the new taxes are almost a year away and could be repealed, it's a good idea to begin planning early. There may be strategies you can implement to minimize the impact.

How it works now

Currently, wages are subject to a 2.9% Medicare tax — 1.45% paid by the employee and 1.45% paid by the employer. Self-employed individuals pay the full 2.9% tax on their self-employment income (generally, 92.35% of their net business income). But the self-employed can subtract one-half of these taxes from their adjusted gross income (AGI).

Unlike Social Security taxes, which apply only up to the wage base ($110,100 for 2012), Medicare taxes apply to 100% of wages or self-employment income. These taxes have never, however, applied to investment income or other "unearned" income.

There are several potential strategies you can implement to reduce or eliminate the 3.8% tax on net investment income.

How the new taxes will work

The Patient Protection and Affordable Care Act of 2010 created the new Medicare taxes to help offset the act's costs. Starting in 2013, higher-income taxpayers will be subject to two new Medicare taxes: 1) an additional 0.9% tax on wages and self-employment income that exceed specified thresholds, and 2) a new 3.8% tax on net investment income to the extent their modified adjusted gross income (MAGI) exceeds those same thresholds.

The thresholds are $200,000 for single filers and taxpayers filing as heads of household, $250,000 for married taxpayers filing jointly, and $125,000 for married taxpayers filing separately. Note that these thresholds impose a "marriage penalty" on certain couples. (See "Complications for joint filers" on page 3.)

For most people, MAGI is equal to AGI. That number may be adjusted upward, however, for certain U.S. citizens or residents who live abroad and have foreign earned income.

Investment income includes:

- Gross income from interest, dividends, annuities, rents and royalties,
- Net capital gains, and
- Trade or business income that is 1) considered passive activity income, or 2) derived from trading in financial instruments or commodities.

Income that falls into the first two categories isn't considered investment income if it's derived from a trade or business, unless it falls into the last category.

Investment income does *not* include distributions from IRAs, pensions, 401(k) plans or other qualified retirement plans — but distributions from these plans can trigger additional Medicare taxes on net investment income by increasing your MAGI.

Once your total investment income is determined, deductible investment expenses are subtracted to arrive at net investment income.

Here are two examples that illustrate how the new taxes work:

Example 1. Steve, who's single, earns $200,000 in wages in 2013 and has no other income. His share of Medicare tax would be 1.45% × $200,000, or $2,900. If Steve's wages were $300,000, he would be taxed as follows: 1.45% × $300,000 + 0.9% × $100,000 ($300,000 - $200,000 threshold) = $4,350 + $900 = $5,250.

Example 2. Suppose Steve's MAGI in 2013 is $250,000, consisting of $175,000 in wages and $75,000 in net investment income. His share of Medicare tax on his wages would be 1.45% × $175,000, or $2,537.50. But he's not subject to the additional 0.9% tax, because his wages are under the $200,000 threshold.

Steve's net investment income is subject to the 3.8% tax, but only on the amount by which his MAGI ($250,000) exceeds the $200,000 threshold. The additional tax would be 3.8% × $50,000, or $1,900.

Complications for joint filers

In many cases the new Medicare taxes (see main article) will have a bigger impact on married couples than they will on single taxpayers. Here's an example showing why:

Howard and Susan are single, and each has MAGI of $200,000 in 2013, consisting of $150,000 in wages and $50,000 in net investment income. Neither exceeds the $200,000 threshold, so neither is subject to the 0.9% or 3.8% taxes.

If Howard and Susan are married filing jointly, however, they'll have to pay both taxes. Their combined wages of $300,000 exceed the $250,000 threshold, resulting in a $450 tax (0.9% × $50,000). And because their $400,000 in MAGI exceeds the threshold, their investment income will be subject to a $3,800 tax (3.8% × $100,000). In other words, they'll pay a $4,250 marriage penalty.

In limited situations, however, a married couple filing jointly might be a little better off compared to filing as singles. This could occur if one spouse has no or very minimal income for the year and the other's wages and/or MAGI are more than the $200,000 threshold(s) for singles but less than the $250,000 threshold(s) for married couples filing jointly.

Minimizing the impact

There's little you can do about the additional 0.9% tax on wages, but there are several

potential strategies you can implement to reduce or eliminate the 3.8% tax on net investment income. They include:

Roth conversion. If you have substantial balances in a traditional IRA, 401(k) or other qualified retirement plan — and you're considering a Roth conversion — now may be the time to do it. Completing the conversion before 2013 will ensure that future distributions are excluded from MAGI, reducing your exposure to the 3.8% tax.

Remember, though, that the conversion amount will be included in your gross income this year and subject to tax (but not the 10% early withdrawal penalty). With ordinary income tax rates scheduled to go up (see "Income and capital gains tax rates scheduled to increase for 2013" at right), a 2013 conversion could be even more costly.

Also keep in mind that you'll have to wait at least five years after the conversion to take distributions from the Roth account or you'll face a 10% penalty.

Selling highly appreciated assets. If you plan to sell highly appreciated assets, consider doing so before 2013 to avoid the 3.8% tax on investment income. This may also be beneficial not only for Medicare tax reasons but also for income tax reasons. (See "Income and capital gains tax rates scheduled to increase for 2013" at right.)

Installment sales. For sales of appreciated assets after 2012, consider using the installment method to spread the gain over several years. Depending on your situation, this may allow you to keep your MAGI below the threshold and avoid the 3.8% tax, or at least minimize your exposure.

Harvesting losses. In years in which you recognize large capital gains, you might want to sell depreciated assets. This would allow you to generate losses that you can offset against the gains, reducing your investment income and your MAGI.

Have a plan

To determine the right strategy for you, work with your advisors to map out your financial and tax situation over the next several years. This will give you an idea of the potential impact of the new Medicare taxes and any options for softening the blow. ◎

Income and capital gains tax rates scheduled to increase for 2013

Without Congressional action, lower rates that were extended for two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 will expire at the end of 2012. Below are the current rates and the rates that, as of this writing, are scheduled to go into effect in 2013. Check with your tax advisor for the latest information.

Rates on ordinary income	
2012	**2013**
10%	15%
15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%
Maximum long-term capital gains rate*	
2012	**2013**
15%	20%

**Certain exceptions apply.*

3 essential estate planning strategies not to be ignored

With most tax planning, there are certain strategies that are just about foolproof and shouldn't be ignored. The same holds true for estate planning. Here are three essential estate planning strategies that will likely help you achieve your goals.

1. Take advantage of the annual gift tax exclusion

Don't underestimate the tax-saving power of the annual gift tax exclusion. Currently, the exclusion is $13,000 per recipient ($26,000 if you split gifts with your spouse).

Watch out for the "three-year rule," which provides that certain assets, including life insurance, transferred within three years of your death are pulled back into your estate and potentially taxed.

If, for example, you and your spouse give away the maximum to five recipients every year for 10 years, you'll have transferred $1.3 million tax-free without using any of your lifetime gift tax exemptions. Annual exclusion gifts can be more effective because, unlike lifetime exemption gifts, they don't reduce the amount of wealth you can transfer tax-free at death under your estate tax exemption. Gifting, whether under the annual exclusion or lifetime exemption, also removes future appreciation from your taxable estate.

2. Use an ILIT to hold life insurance

Do you own an insurance policy on your life? Then be aware that a substantial portion of the

proceeds could be lost to estate taxes. The exact amount will depend on the the estate tax exemption available at your death as well as the estate tax rates that apply.

However, if you don't own the policy, the proceeds won't be included in your taxable estate. An effective strategy for keeping life insurance out of your estate is to set up an irrevocable life insurance trust (ILIT) to buy and hold the policy.

If you already own your life insurance policy, you can transfer the policy to an ILIT. But watch out for the "three-year rule," which provides that certain assets, including life insurance, transferred within three years of your death are pulled back into your estate and potentially taxed.

3. Place assets in a credit shelter trust

Designating your spouse as your sole beneficiary may seem like a good strategy. But doing so can waste your estate tax exemption.

Suppose you leave everything to your spouse. There will be no current estate tax at your death because of the unlimited marital deduction (assuming your spouse is a U.S. citizen).

When your spouse dies, however, the assets transferred to him or her at your death will be included in his or her taxable estate (assuming the assets remain intact). A substantial portion of your spouse's estate could be subject to estate tax, depending on a variety of factors such as the size of your spouse's total estate and the estate tax exemption available at his or her death.

You can preserve your exemption and reduce or even eliminate estate taxes by placing assets in a credit shelter trust. If properly structured, the trust provides your spouse with income for life — and access to the principal as needed — but the assets aren't included in his or her estate. Plus, your own exemption shields the trust assets from estate tax.

Work with a pro

There's much you need to consider when developing or reviewing your estate plan. Make sure you work with a qualified tax advisor, so you can keep your plan on the right track. ◎

S corporation shareholder-employees: Are your salaries high enough?

S corporations have a big tax advantage over other pass-through entities, such as partnerships and limited liability companies (LLCs): Shareholder-employees aren't subject to self-employment taxes on their share of the corporation's income. Minimizing shareholder-employee salaries and maximizing income distributed to them in the form of dividends can save significant payroll taxes.

So, it's no surprise that the IRS casts a wary eye on S corporation shareholder-employee salaries. If the agency concludes that salaries are unreasonably low, it may recharacterize a portion of dividends paid to shareholder-employees as wages and present the company with a bill for unpaid payroll taxes, interest and penalties.

To determine whether a salary is reasonable, the IRS analyzes several factors, including the shareholder-employee's training and experience, duties and responsibilities, and time and effort devoted to the business. It also examines the company's dividend history, salaries paid to nonshareholder employees, and salaries paid by comparable businesses for similar services. The IRS may also consult published financial ratios for the company's industry, such as average compensation as a ratio of sales or profits.

It's a good idea to conduct your own investigation before the IRS does. If you don't, IRS auditors may come to their own conclusions as to what constitutes a reasonable salary based on their limited knowledge of your company and its industry. But if you provide them a well-documented road map that demonstrates your salaries' reasonableness, they may defer to your judgment. So scrutinize your shareholder-employees' salaries in light of the factors above. Then document their reasonableness with industry statistics, compensation surveys, and information about your company's activities and finances.

tax TIPS

Retirement plan penalty exception turns into a tax trap

Ordinarily, distributions from a qualified retirement plan before age 59½ are subject to a 10% early-withdrawal penalty. But Internal Revenue Code Section 72(t)(A)(v) creates an exception for "distributions … made to an employee after separation from service after attainment of age 55…."

Unfortunately, this language is ambiguous. Does the exception apply to distributions made after age 55 regardless of when the employee separates from service? Or must the separation from service also occur after age 55?

In a recent U.S. Tax Court case, a taxpayer learned the answer the hard way. She retired at age 53 but waited until she turned 55 to take distributions from her employer's qualified plan. The IRS determined she was liable for the 10% penalty, and the court agreed. Sec. 72(t)'s legislative history states that "the exception applies only if the participant has attained age 55 on or before separation from service." ◎

Charitable trust is a powerful investment tool

A charitable remainder trust (CRT) can be an effective estate planning tool. It enables you to remove wealth from your estate, enjoy an immediate charitable income-tax deduction and avoid estate taxes on future appreciation — while continuing to receive income from the trust assets. You transfer securities or other assets to the trust, retaining an annual income stream for life or for a term of up to 20 years. At the end of the term, the remaining assets go to charity.

A CRT also allows you to implement investment strategies in a tax-efficient manner. For example, because the trust is tax-exempt, the trustee can sell highly appreciated assets without a capital gains tax bite and reinvest the full amount of the proceeds. Income you receive from the trust is taxable, however. ◎

Buying or selling a business? Consider an installment sale

In the current economy, many business owners are having trouble finding buyers, while many buyers are having trouble securing needed financing. An installment sale may help both.

It expands the pool of potential buyers by reducing their financial burden — essentially by having the seller finance the purchase. And with today's historically low applicable federal rates, a greater portion of the payments the seller receives may be taxed favorably as long-term capital gain rather than unfavorably as interest income.

Keep in mind, however, that tax rate increases could make an installment sale more costly. (See "Income and capital gains tax rates scheduled to increase for 2013" on page 4.) ◎

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