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Family Tax Planning Forum

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Using Income Smoothing to Minimize the Effects of the 3.8-Percent Medicare Surtax and ATRA

The 3.8-percent Medicare surtax and the American Taxpayer Relief Act of 2012 (ATRA)[1] added substantial progressivity to ordinary income and capital gains rates. They not only increased the top rates, but created a number of new marginal tax brackets. When the surtax is taken into account, there are now ordinary income tax rates of zero percent, 10 percent, 15 percent, 25 percent, 33 percent, 35 percent, 36.8 percent, 38.8 percent, 39.6 percent and 43.4 percent and capital gains rates of zero percent, 15 percent, 18.8 percent, 20 percent and 23.8 percent. The higher rates and increased number of tax brackets makes year-to-year planning to smooth out income and stay in a lower tax bracket more important.

The changes in the rate structure should make deferred annuities, charitable remainder trusts, installment sales and life insurance and more popular.

Tax-Deferred Annuities

One client situation that planners may encounter is a taxpayer who currently has income subject to both the 39.6-percent marginal income tax rate and the surtax, but who expects to have much lower income during retirement. The perfect tax solution for such a client may be a deferred annuity, which can shift income currently taxed at 43.4 percent to years when it may be taxed at a much lower rate. Consider the following example:

Example 1. John, a single taxpayer, has $400,000 of salary income and a $2 million corporate bond portfolio that produces $100,000 of annual

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interest income. John expects to have the same income for the next 10 years, after which he will retire. After retirement, he will have $100,000 of annual income from a Roth IRA plus the income from the bond portfolio. Assume that John's salary provides sufficient income and he doesn't need the income from the bond portfolio.

If John does no planning, he will pay a very high rate of tax on his last $100,000 of current income. It will be taxed in the new 39.6-percent top ordinary income tax bracket, which begins at $400,000 for single taxpayers. It will also be net investment income subject to the 3.8-percent surtax because John's income exceeds the $200,000 applicable threshold amount (ATA) for a single taxpayer. This makes the effective tax rate 43.4 percent (39.6 + 3.8). The tax payable will be $43,400.

A better tax alternative might be for John to invest the $2 million in a deferred annuity. Suppose that given John's age at retirement, the $2 million will buy an annual annuity of $150,000 per year. By purchasing the deferred annuity, John will eliminate all current income above $400,000. This will keep John out of the 39.6-percent bracket for the next 10 years and will also eliminate any surtax payable because John no longer has any net investment income.

After retirement, John will have total income of $250,000 per year ($150,000 from the deferred annuity and $100,000 from the Roth IRA). Because the distributions from the Roth IRA are not subject to tax, John will have taxable income (MAGI) of $150,000. This income would be taxed at a maximum rate of 28 percent. Although the annuity payments are net investment income, the surtax would not apply because John's MAGI is below his applicable exclusion amount of $200,000. By purchasing the deferred annuity, John has converted income taxed at 43.4 percent to income taxed at 28 percent, 25 percent, 15 percent and 10 percent.

Charitable Remainder Trusts

Charitable remainder trusts (CRUTs and CRATs) are particularly useful when a taxpayer has a large capital gain for a tax year that pushes his or her income into a higher tax bracket. If a taxpayer contributes an appreciated asset to a CRT and the CRT sells it, the trust recognizes no gain because it is a tax-exempt entity. The gain is eventually taxed to the donor, but only as annual annuity or unitrust payments are received. Thus, CRTs can be used to spread the gain out over a period of time to keep the taxpayer in lower tax brackets and perhaps avoid the surtax.

The character of the distributions is determined under the ordering rules of Code Sec. 664. Under these rules, distributions are first treated as ordinary income to the extent of the current and accumulated ordinary income of the CRT, second as capital gains to the extent of the trust's capital gains, third as other income (*e.g.,* tax-exempt income) and finally as tax-free return of trust corpus.

Example 2. Bev, a single taxpayer, has salary income of $100,000 and no other income in 2013. She sells XYZ stock inherited from her grandfather and recognizes a gain of $400,000. The first $300,000 of capital gain is taxed at 15 percent and the last $100,000 at 20 percent under the income tax. The 3.8-percent surtax also applies to part of the gain. Bev has $400,000 of net investment income and $500,000 of MAGI. So she is subject to the surtax on the lesser of NII ($400,000) or MAGI – ATA ($300,000). Thus, the total tax rates are 15 percent on the first $100,000 of gain, 18.8 percent on the next $200,000 and $23.8 percent on the last $100,000. The total tax paid is $76,400 (0.15 x $100,000) + (0.188 x $200,000) + (0.238 x $100,000).

Example 3. Assume the same facts as Example 2 except that instead of selling the stock herself, Bev contributes it to a CRAT, which sells the stock and realizes a gain of $400,000 but pays no tax. Suppose that the CRAT pays Bev $100,000 per year for 10 years. To keep the analysis as straightforward as possible, assume that the trust has no other income so that all distributions carry out only capital gains from the sale of the stock. The distributions to Bev are taxable to her as capital gain until the $400,000 of gain realized on the sale is used up. Thus, Bev has $100,000 of capital gains in each of the next four years. This increases her annual income to $200,000 per year. Because this amount does not exceed her ATA, the surtax does not apply. Thus, the CRAT distributions are taxed to Bev at the 15-percent rate. The total tax payable is $60,000 (4 x $15,000). Note that this is $16,400 less tax paid than in Example 2 ($76,400 – $60,000).

Installment Sales

Installment sales are another strategy that can be used to spread large capital gains over a number of tax years. They have one very important advantage over charitable remainder trusts—there is no need to give anything to charity, so the payment stream represents the full value of the asset transferred. By contrast, with a charitable remainder trust, the present value of the charity's lead annuity or unitrust interest must be at least 10 percent of the value of the assets transferred to the trust.

Charitable remainder trusts also have some advantages compared with installment sales:

- The full value of the assets sold can be reinvested immediately with no reduction for capital gains tax paid. This can facilitate diversification of a concentrated low-basis portfolio. By contrast, with an installment sale, reinvestment funds are acquired a little at a time, so reinvestment is delayed and the amount available for reinvestment is reduced by the amount of capital gains tax paid.
- A charitable remainder trust with a life term may transfer more value to family members in the long run than a sale if the taxpayer lives long enough.
- If assets grow faster than the Code Sec. 7520 rate, the remainder interest will be undervalued and heirs will receive excess value. By contrast, favorable performance of assets sold in an installment sale provides no added benefit for the transferor's family.

Life Insurance

Like a deferred annuity, life insurance can be used to shift income from years when a taxpayer is in a high tax bracket to years when the taxpayer is in a lower tax bracket. Because amounts borrowed from a life insurance policy are not subject to tax until basis has been recovered, policy owners can also use life insurance to add tax-free income in low earning years or create additional tax-free income for a special project or investment.

Example 4. Harry, a single taxpayer, expects to have $200,000 of salary income in each of the years from 2013 through 2022, after which he plans to retire. After retirement, he expects his income to drop to $160,000 per year. Harry also has a $200,000 corporate bond portfolio that pays five-percent interest, giving him $10,000 of net investment income each year. If Harry does nothing, he will pay $380 of surtax each year until 2022 (0.038 x $10,000). Instead, he sells the bond portfolio and uses the proceeds to buy a life insurance policy. This eliminates the surtax for 2013–2022 and enables Harry to increase his income in any year after 2013 without paying any tax.

Example 5. Assume the same facts as Example 4, except that Harry's income fluctuates significantly from year to year. Harry needs $100,000 per year for his living expenses. His income for 2013–2016 is as follows:

- 2013.............$125,000
- 2014.............$110,000
- 2015..............$105,000
- 2016..............$70,000

In 2016, Harry could borrow $30,000 to bring his income up to the required $100,000 without paying any tax on the additional income.

Conclusion

Using tax-deferred annuities, charitable remainder trusts, installment sales and life insurance to smooth out income may save taxpayers significant amounts on taxes beginning in 2013.

Endnote

1 American Taxpayer Relief Act of 2012 (P.L. 112-240).