PARTNERS
WEALTH MANAGEMENT

Fourth Quarter 2012 (630) 778-8088/info@partnerswealth.com

# Seven Ways To Sidestep The 3.8% Medicare Surtax

Under the 2010 health-care law—the Patient Protection and Affordable Care Act of 2010—a new 3.8% Medicare surtax will take effect in 2013, absent any further legislation from Congress.

The surtax applies to the lesser of your net investment income or the amount by which your modified adjusted gross income (MAGI) exceeds \$250,000 if you're filing jointly and \$200,000 for single filers. For this purpose, "net investment income" includes interest, dividends, royalties, rents, gains from dispositions of property, and income from passive activities. But tax-exempt interest or distributions from traditional IRAs and Roth IRAs and qualified retirement plans don't count.

The new surtax also applies to trusts and estates under comparable rules. But you may be able to limit the impact of the new levy by acting before it takes effect. Here are seven potential planning techniques to consider:

**1. Municipal bonds.** Because the definition of net investment income doesn't include tax-exempt interest, you could expand your holding of municipal bonds and municipal bond funds that pay tax-free interest. Munis are especially attractive if you're in the higher tax brackets. (Certain "private activity bonds" could cause other problems, however, producing income subject to the alternative minimum tax, or AMT.) In addition, the interest income from munis won't increase your MAGI for purposes of the \$250,000/\$200,000 surtax threshold.

**2. Tax-deferred annuities.** An annuity is basically a contract between you and a financial institution. In return for your premiums, the insurance company or other institution agrees to pay you a certain amount of income in the future, for a specified term of years or for your lifetime. The annuity can be "fixed," with pre-established payouts, or "variable," based on the performance of underlying investments. An annuity could help you avoid the Medicare surtax by deferring payments until you're past the high-income years when you'd be more likely to earn enough to pay the surtax.

**3. Life insurance policies.** All of the usual reasons for acquiring permanent life insurance still apply. For instance, insurance can provide a cash windfall at your death that your beneficiaries could use to pay taxes and other debts. If handled correctly, the proceeds may be exempt from both federal income and estate tax. What's more, you may be able to borrow against the cash value of the policy while you're alive. By removing cash from a policy, up to the amount of your basis, you can avoid the 3.8% surtax that applies to most other income.

**4. Rental real estate.** If you invest in real estate, you can offset rental income with deductions for expenses,

*(Continued on page 4)*

## *Thank You For The Trust You Have Placed In Us*

The holidays are a time of year that we, along with our family and friends, can take a moment to reflect on the things for which we are grateful.

At Partners Wealth Management, we are thankful to you — our clients. Longstanding relationships that have endured through good and bad economic times have brought us closer to many of you. We now have developed a shared history of trust, enriching our lives in ways that were unexpected. Our newer clients, meanwhile, are coming to us with new challenges and, thus, breathe new energy into our practice. All of our clients are important to us and we are grateful for the trust you have placed in us.

Personally, I am thankful for the dedicated team that works at PWM. These fine people are striving daily to find innovative solutions to address your personal situation. They are caring people of integrity, and I am grateful for the diligence they show in serving our clients.

As we come to the close of 2012, please consider contacting us to update your plans and review your investments. Please also feel free to introduce us to your friends and family and allow us the privilege of serving them.

Enjoy this season of gratitude. We look forward to serving you in the New Year and wish you prosperity, love, and peace of mind!

John

# Splitting Income With Your Family

Shifting taxable income to other family members—usually children or grandchildren—who are in lower tax brackets is a time-tested tax planning technique. It may enable you to reduce overall taxes for your family. But this strategy could be especially valuable now. Barring last-minute changes from Congress, tax rates on ordinary income will be adjusted upward in 2013. At the same time, favorable tax breaks for capital gains and dividends will be scaled back.

If you own income-producing property, such as securities or real estate, you're taxed on the income from those assets in your own higher tax bracket. But your children and grandchildren are likely to be taxed at lower rates, and if you can shift tax liability for the property to the younger generations, your family will pay less in taxes.

Typically, you might give the property to a family member through a direct gift. More sophisticated arrangements may involve the use of a trust. Either way, income from the property is taxed to the family member in a lower tax bracket instead of to you in your higher bracket.

What makes this strategy even more attractive now is that tax rates are going up. In 2012, ordinary income is taxed under a six-rate structure with a top rate of 35%. Also, the maximum tax rate for long-term capital gains and dividends is 15%, reduced to 0% for those in the 10% and 15% ordinary income brackets. Absent new legislation, the tax rate structure for 2013 will be adjusted to reflect five brackets and a top rate of 39.6%. The maximum tax rate on net long-term capital gains is set to increase to 20% for most taxpayers and to 10% for investors in the 15% tax bracket (the lowest under the new rules). Qualified dividends will be taxed at ordinary income rates.

Suppose you own property that produces annual income of $20,000. If you're in the top bracket in 2013, you'll pay $7,920 in tax on the income (39.6% of $20,000). But a child in the 15% tax bracket would owe tax of only $3,000 (15% of $20,000) on the same income—$4,920 less.

There are other tax ramifications to consider, however. A transfer of property is subject to gift tax, although you're allowed an annual gift tax exclusion ($13,000 per recipient in 2012) as well as a lifetime exemption (for combined lifetime and estate gifts) of $5.12 million in 2012. The biggest impediment to this strategy may be the "kiddie tax," which applies to investment income above an annual limit ($1,900 in 2012) for a child under age 19 or a full-time student under age 24. In those cases, income that exceeds the threshold will be taxed at the top rate of the child's parent.

Finally, remember that you're giving up ownership of property when you transfer it to family members. The best approach is to incorporate income-splitting into an overall plan. ●

# Don't Forget The 'Other' Surtax

In the wake of the Supreme Court ruling upholding the constitutionality of the 2010 health-care law, much of the focus has shifted to the 3.8% Medicare surtax that will apply to some high-income investors beginning in 2013. And this is with good reason. Those who are in the top 39.6% tax bracket then may pay an effective federal rate of as much as 43.4% on a portion of their investment income. Add in state taxes, and the new levy could be truly painful.

Yet there's another new Medicare surtax that hasn't received much attention. Beginning in 2013, you will have to pay an extra 0.9% tax on "earned income" which exceeds an annual threshold—$200,000 for single filers and $250,000 for joint filers. It's a relatively straightforward calculation—unlike the larger new surtax, which depends on how much income you receive from your investments as well as your overall earnings.

And while this additional new tax may seem small, it comes on top of the 3.8% Medicare surtax, plus your regular federal and state income tax liability. What's more, if your income is high enough, you might owe this tax year in and year out. It really can add up.

Take the example of a single filer who earns $500,000 a year. Starting in 2013, this person will have to pay an extra 0.9% surtax on the $300,000 that exceeds the $200,000 threshold, or $2,700 (0.9% of $300,000). Now assume that the figures stay the same for the next 10 years. As a result, this taxpayer will have to fork over a total of $27,000 (10 years x $2,700).

For the purpose of calculating the surtax, you can rely on the usual IRS definition of "earned income," which includes the following:

- Wages, salaries, tips, and other taxable employee earnings,

# Where Retirees Live, And Why

Do you know where you will live after you retire? You might decide to stay in your current home, move to a smaller place, or relocate to be closer to your children. You could opt for a warmer climate—or for someplace colder. You may settle in another state, or even another country. There are so many possibilities it can seem confusing to sort through them all.

Your first consideration, of course, is what will be best for you. What you can afford, whether you're in good health, what your spouse wants—all of those have to be factored into your decision. If your mortgage is paid off, staying put could be the most economical option. Of course, downsizing could put spending money in your pocket or pad your retirement account. Maybe you need to provide financial help to your children, grandchildren, or even your parents. Other considerations include state income taxes and proximity to family members.

Whatever your situation, retirement is a momentous occasion, and the more you think about how you want it to play out—and the earlier you start planning—the more likely you'll have a satisfying life after work.

Not many years ago, retirement didn't last very long, and most people just lived out their days quietly. But times have changed. According to the U.S. Centers for Disease Control and Prevention, the average 65-year-old in 2009 could expect to live another 19 years—and that's more than one and a half years longer than in 2000. Active retirements have become the rule, not the exception, and many people continue to work at least part time.

Spurred by these trends, retirement communities have sprung up all across the country, even in cold-weather states. You can find retirement communities in the mountains, on the prairie, on lakes—just about anywhere, from sea to shining sea. They may be built for a few dozen residents, or many thousand. At The Villages near Ocala, Florida, more than 51,000 retirees live and scoot around in golf carts.

A retirement community can consist of just one kind of housing—condominiums or single-family homes, for instance—or you may be able to choose from among many different options. And these days, such places frequently call themselves active adult communities, dropping the word retirement to emphasize the physically active nature of today's senior lifestyles.

And life at a retirement community—by any name—can be very active indeed, with recreational choices that may include golf courses, tennis courts, bocce courts, Olympic-size swimming pools, spas, and boats and canoes. There could be walking trails, bike trails, community newspapers, stage shows (with seniors doing the acting), seminars on health and other topics, billiard tables, ceramics classes, photography clubs, computer clubs, and state clubs. You may get a place to store your boat or your recreational vehicle, and just about every retirement community has a clubhouse, complete with card rooms, craft rooms, bingo halls, dance halls, libraries, TV rooms, and, of course, an office staff ready to assist you. And because most communities have a minimum age requirement of 55 or so, you'll beliving with people mostly from your own generation—and you won't be disturbed by a lot of noisy children running around. (You can visit your grandchildren for that!)

State clubs are amazingly popular in retirement communities. It seems that many people prefer mixing socially with others from their home states rather than with people from other parts of the country. Another surprising thing about state clubs is that those with the most members often don't represent the most populous Northern states. In Florida, the retirement-haven state, Michigan seems to lead all other states in retirement club membership.

All retirement communities have homeowner associations—and homeowner association fees that can range in cost from low to moderate to very expensive, depending on the types and numbers of amenities and services offered. Before choosing a place, be sure to consider not just the initial cost of buying a house or a condo but also all of the fees and other recurring expenses. You might rent a place first to try it out.

Yet while you may be reluctant to pay a hefty monthly homeowner association fee, it's likely to cover a host of convenient services ranging from basic cable TV and garbage collection to lawn maintenance, pest control, exterior painting and other maintenance, and roof repair. And if you've ever cut grass on a hot, muggy, Florida summer day, you might agree that lawn maintenance alone makes retirement community living worth the price! ●

- Union strike benefits,
- Long-term disability benefits received prior to minimum retirement age,
- Net earnings from self-employment if you own or operate a business or if you're a minister or member of a religious order,


- Gross income received as a statutory employee.
- On the other hand, the IRS says the following items are not included under its definition of earned income:
- Pay received for work while an inmate in a penal institution,
- Interest and dividends,
- Retirement income,
- Social Security benefits,
- Unemployment benefits,
- Alimony,
- Child support.

Finally, business owners don't have to fret about doubling up on the surtax. The 0.9% levy applies only to employees who exceed the income threshold, not to the business entity that provides their salaries. At least that's a small consolation if you're stuck with this extra tax liability. ●

# Getting In On The "Ground Floor"

Suppose you want to diversify your holdings by investing in real estate. Or maybe you believe that the real estate market, in the doldrums for years, is ready to bounce back. Even with depressed prices throughout most of the country, you'll still have to pay a pretty penny to acquire a building or a parcel of land in a prime location.

But you don't necessarily have to go whole hog. Instead of buying a property outright, you might acquire shares in a real estate investment trust (REIT). It's akin to buying shares of a mutual fund, so this type of investment hedge doesn't have to cost you a small fortune.

Although past performance is no guarantee of future results, REITs did outperform a couple of notable benchmarks last year. According to the National Association of Real Estate Investment Trusts (NAREIT), the yield on the average REIT in 2011 was 4.34%, compared to an average dividend yield of 2.1% for the Standard & Poor 500 stock index and an average yield of 1.87% for 10-year Treasury notes.

A REIT is a corporate entity that invests in real estate properties in much the way a mutual fund invests in stocks. Professional managers handle the portfolio, and if the REIT meets certain requirements, it gets favorable tax treatment. Due to income and tax reporting rules for REITs, such investments are often held in retirement accounts.

There are three basic types of REITs:

**1. Equity REITs.** These are by far the most common type. An equity REIT holds physical real estate properties—typically, shopping malls, hotels, hospitals, offices, or timberland—that generate rental income. Some equity REITs focus on properties in a particular geographic area. A REIT's properties usually are purchased to be part of a portfolio of investments instead of being developed for resale.

**2. Mortgage REITs.** A mortgage REIT originates and buys or sells mortgages for property owners. The loans are secured by real estate, mortgage-backed securities, or existing mortgages. Essentially, this type of REIT is a finance company. The main revenue source is interest from the mortgages.

**3. Hybrid REITs.** These combine elements of equity and mortgage REITS, including direct property ownership and mortgage lending. They earn both rental and interest income, and can provide diversification within a single investment.

A REIT doesn't have to pay corporate income tax if it distributes at least 95% of its net annual earnings as dividends. And though REIT income generally doesn't qualify for the favorable 15% maximum tax rate that applies to "qualified" dividends in 2012, beginning in 2013 all dividends (including REIT dividends) are scheduled to be taxed as ordinary income. Barring a last-minute legislative change, REITs then will be on a level playing field with stocks that pay dividends.

Are REITS the right investment for you? We can analyze your situation. Give us a call. ●

## Ways To Sidestep

*(Continued from page 1)*

including a depreciation write-off under applicable IRS tables. In some cases, you might even be able to claim a loss on the enterprise, although losses are restricted or eliminated for high-income taxpayers under "passive activity" rules. Even if you show a modest positive income, the depreciation deduction can limit your MAGI, making this a good way to avoid the surtax.

**5. Oil and gas deals.** Another classic tax-minimizing technique may see a revival due to the Medicare surtax. Prior to a tax-law crackdown in the 1980s, investors often used losses sustained in oil- and gas-drilling partnerships as a way to shield income from tax. Today's rules are stricter, although you still may be able to benefit if you own a "working interest" in an oil or gas deal.


**6. Choice of tax year.** The administrator of a trust or estate generally has some flexibility in determining the tax year of the entity. As a result, it may be advisable to use a tax year that begins at the end of 2012, rather than in 2013, so the income for that entire tax year won't be subject to the Medicare surtax.

**7. Trust distributions.** Similarly, distributions from a trust could be subject to the 3.8% Medicare surtax, beginning in 2013. However, any distributions made in 2012 can't trigger the surtax (although they will be otherwise subject to income tax). Depending on your circumstances, you might arrange to have a trust make sizable distributions before the end of the year.

These opportunities may or may not work for you, and there could be other strategies that might help you limit your exposure to the new Medicare surtax. Work with your tax and financial advisors to choose a course of action that makes sense in your situation. ●