Dear Client:

Starting in 2013, high-income taxpayers will face a 3.8% additional Medicare contribution tax on net investment income (the net investment income tax or NIIT). Here's an overview of the new tax and steps you can take to reduce its impact.

The NIIT is an extra tax that is imposed in addition to your regular income tax. You will be subject to the NIIT only if your modified adjusted gross income (MAGI) exceeds $250,000 for married taxpayers filing jointly and surviving spouses, $125,000 for married taxpayers filing separately, $200,000 for unmarried taxpayers and heads of household. The amount actually subject to the tax is the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold.

The following types of income and gain (net of related deductions) are included in the definition of net investment income and so may be subject to the NIIT: (1) gross income from interest, dividends, annuities, royalties, and rents, unless those items were derived in the ordinary course of an active trade or business; (2) other gross income from passive activities; and (3) taxable net gain from dispositions of property other than property held in an active trade or business.

There are also major categories of income that are exempt from the NIIT. Any item that is excluded from income for income tax purposes is likewise excluded from the NIIT. This means that tax-exempt interest and the excluded gain from the sale of your main home aren't subject to the tax. Distributions from qualified retirement plans, including individual retirement accounts (IRAs) and Roth IRAs, aren't subject to the NIIT. Wages and self-employment income aren't subject to the NIIT, though they may be subject to a different Medicare surtax.

It's important to remember the NIIT applies only if you have net investment income and your MAGI exceeds the applicable thresholds discussed above. So, consideration should be given to the following strategies that may minimize net investment income:

- If your income is high enough to trigger the NIIT regularly, shifting some income investments to tax-exempt bonds could result in less exposure to the NIIT. Tax-exempt bonds both lower your MAGI and avoid the NIIT.
- Dividend-paying stocks will be taxed more heavily as a result of the NIIT. The maximum income tax rate on qualified dividends is 20%, but with the NIIT added on the rate becomes 23.8%. As a result, you may want to consider rebalancing your investment portfolio to emphasize growth stocks over dividend-paying stocks. While the resulting capital gain from these investments would also be included in net investment income, there are two potential benefits: (1) the tax will be deferred because the capital gain won't be subject to the NIIT until the stock is sold, and (2) capital gains can

be offset by capital losses, which is not the case with dividends.

Because distributions from qualified retirement plans are exempt from the NIIT, upper-income taxpayers with some control over their situations (i.e., small business owners), might want to make greater use of qualified plans. For example, creating a traditional defined benefit pension plan will increase tax deductions now and generate future income that may be exempt from the NIIT.

Consider donating appreciated securities to charity rather than donating cash. This will avoid capital gains tax on the built-in gain of the security and avoid the 3.8% NIIT, while generating an income tax charitable deduction equal to the fair market value of the security. You could then use the cash you would have otherwise donated and repurchase the security to achieve a step-up in basis.

As mentioned above, income, gains, losses, and allocable deductions from passive activities are generally included in net investment income and subject to the NIIT. If your level of activity is increased so that the business income becomes nonpassive, the tax can be avoided.

In determining whether an activity is active or passive, there are rules governing what constitutes an "activity" and how different activities are aggregated. The general passive activity loss (PAL) rules give some leeway to group trades or businesses or rental activities together to satisfy the material participation standards and avoid characterization of activities as passive. In general, a taxpayer's initial grouping of activities can't be changed unless the prior grouping is clearly inappropriate or there is a material change in facts and circumstances. However, recognizing that the activity groupings that are used for regular PAL purposes now also apply for NIIT purposes, proposed regulations issued by IRS permit you to make a "fresh start" by regrouping activities.

You can make the regrouping election in 2013 if you are subject to the NIIT in 2013. If you don't make the election for 2013, and the final regulations contain the same or a similar election, you may make the election for the first tax year beginning after 2013 that you are subject to the NIIT. Only one regrouping is permitted, and it is effective for all subsequent years.

Please keep in mind, however, that although the regrouping privilege can be used to treat net income from the newly combined group as non-passive business income and avoid the NIIT on that income, this can have the negative effect of transforming passive income that can be offset with passive losses into nonpassive income that can't be offset by passive losses.

It appears that net rental income from a self-rental situation will be subject to the NIIT. A self-rental occurs when property that you own is rented for use in a trade or business activity in which you materially participate. If this is the case, the net rental activity income for the year from that property is treated as nonpassive income, even though rental income is generally passive. Despite this, the income is still subject to the NIIT, because rents are considered investment income even though the income is nonpassive. However, there may be planning opportunities as a result of the grouping rules discussed above. There are situations where the rental activity and the business activity in a self-rental situation can be grouped together under the passive activity rules, but it isn't clear from the IRS regs if making this grouping election removes the rental income from net investment income.

As you can see, the NIIT may have a significant effect on your tax picture going forward. Anyone who might be subject to the tax should plan for these changes in 2013 and beyond. We would be happy to meet with you to discuss the NIIT and tax-planning strategies so that the impact of the NIIT can be minimized.

Very truly yours,

Cohen & Grieb, P.A.