

ABOUT THE AUTHOR



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Sources: irs.gov. Each individual's tax and financial situation is unique. This information has been prepared solely for informational purposes and is not intended to provide or should not be relied upon for accounting, legal, tax or investment advice. Please consult with your tax and/or legal advisor with regard to your individual circumstances. The factual statements herein have been taken from sources believed to be reliable, but such statements are made without any representation as to accuracy or completeness. Opinions expressed are current as of May 2010, and are subject to change due to changes in the legal and/or regulatory environment surrounding the issues discussed.

For more information about federal and state taxes, please consult the Internal Revenue Service code and the appropriate state-level departments of revenue, respectively.

Paying for Health Care Reform — What's Your Share of the Bill?

It's here ... the 3.8% unearned income Medicare contribution tax! The 2010 Health Care Reconciliation Bill added new tax provisions to the Internal Revenue Code. For affluent individuals, we believe the most important of these is the 3.8% surtax on unearned income. The tax landscape is now even more complicated, as additional layers of taxes with differing rules and mitigation strategies converge. Knowing the where, when and why allows for effective planning—and this planning may significantly reduce your tax liability.

A Surtax on What?

For individuals, the 3.8% surtax will be assessed on the lesser of:

- (a) Net investment income or:
- (b) Modified adjusted gross income which exceeds the threshold amount

This threshold is \$250,000 for joint filers and surviving spouses, \$200,000 for single filers, and \$125,000 for married individuals who file separate returns. Individuals who fall below the threshold will not be subject to the tax, regardless of the amount of net investment income they earn.

Example 1: A couple has \$50,000 of interest and dividends and modified adjusted gross income (MAGI) of \$225,000. Since the surtax would be assessed on the lesser of \$50,000 or the amount of MAGI in excess of \$250,000 (in this case, \$0), there would be no surtax.

What qualifies as "net investment income"?

For purposes of the surtax, net investment income is gross income from interest, dividends, annuities, royalties, rents, capital gains, passive activity income and certain other income from trading in financial instruments or commodities, minus allowable deductions. So, investors who earn investment income from marketable securities portfolios (including capital gains) and net income from passive activity (including earnings from rental properties) may find themselves subject to this surtax.

Gross income does not include tax-exempt bond interest, gains from the sale of a principal residence and retirement distributions. (For purposes of this article, retirement distributions include taxable distributions from traditional IRAs and traditional qualified retirement plans.)

Retirement Distributions Can Trip the Surtax Trigger

Even though these retirement distributions aren't considered investment income, they could push a taxpayer into surtax territory. For most taxpayers, MAGI is adjusted gross income, as shown on line 37 of the 2009 Federal Form 1040. Retirement distributions are included in adjusted gross income and therefore, in MAGI.

Let's take a closer look in Example 2.

Example 2: A couple has investment income of \$225,000 and no other income in year 1. They are not subject to the 3.8% surtax because they do not cross the \$250,000 MAGI threshold.

In year 2, the couple earns the same amount of investment income. However, they also take a 5% distribution from their \$3,000,000 traditional IRA. Their MAGI is \$375,000 (\$225,000 in investment income, plus \$150,000 from the traditional IRA distribution). Because their MAGI exceeds the threshold amount of \$250,000 by \$125,000, they are now subject to the 3.8% surtax on \$125,000 (the lesser of the net investment income or the amount in excess of the MAGI threshold).

Roth to the Rescue?

What would have happened if the \$150,000 distribution had come from a Roth IRA instead of a traditional IRA? No surtax!

This is because Roth IRA distributions are not included in adjusted gross income. Therefore, Roth distributions are not a component of MAGI. If the distributions had been from a Roth, the couple's MAGI would have remained \$225,000—under the \$250,000 threshold for the surtax.

Does this mean that everyone with a traditional IRA should convert to a Roth IRA? Not necessarily—if only it were that simple! There are many considerations that should be factored into the conversion decision.

What's clear is that the new surtax increases the importance of income tax planning, particularly for those with:

- > Significant investment income (more than \$50,000 annually)
- > Adjusted gross incomes of more than \$250,000
- > Adjusted gross income of approximately \$200,000 (including significant investment income), who will begin to take taxable distributions from larger-balance (\$1,000,000+) traditional IRAs in the coming years.

A Window for Planning

To ease the pain, the surtax doesn't kick in until tax years beginning after December 31, 2012. This provides time for review and planning.

Taxpayers may wish to consider these strategies:

1. Increased contributions to IRAs and other qualified plans. This may be particularly worthwhile for taxpayers with earned income near the threshold amount, as contributions could possibly reduce adjusted gross income. That said, it's important to consider if distributions

from those accounts during retirement would push MAGI above thresholds.

2. Conversion of Traditional IRAs to Roth IRAs prior to January 1, 2013. Amounts converted are included in adjusted gross income and may cause a surtax in year of conversion post-December 31, 2012. Distributions from Roth IRAs are excluded from adjusted gross income and will not affect the surtax calculations.

3. Increased allocations to tax-exempt bonds. Income from tax-exempt bonds is not included in investment income and may become more attractive compared to investments with taxable income.

Can You Lessen the Tax Bite?

There's a popular saying, "The only certain things are death and taxes." But even if taxes are a certainty, the specifics are anything but. The unknowns make it difficult to implement a long-term tax strategy: What will future politicians do with income tax laws? How will future tax law changes effect the decisions taxpayers make between now and 2012? Absent a crystal ball, these questions are largely unanswerable. With a Presidential election in 2012, it's even possible that the new surtax could be eliminated before it's implemented. When it comes to taxes, the only thing we can be certain of is change.

That said, we don't believe taxpayers should sit by idly. The surtax, plus an expected increase in the highest federal tax rate to 39.6%, could push federal income taxes on investment income to 43.4% for some taxpayers. For certain residents of high-taxing states, the combined federal and state rate could approach 55%. Now more than ever, income analysis and projections are essential to tax planning and asset preservation strategies.

The Calamos Wealth Management group can provide you with additional assistance. Please contact us at 888.857.7604 for more information.

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