SPECIAL REPORT:
ESTATE PLANNING & TAXATION

By **Robert T. Napier**

The 3.8 Percent Healthcare Tax

"Say hello to my little friend!"

In the movie "Scarface," Al Pacino inhospitably quips, "Say hello to my little friend!" He could easily have been introducing the new healthcare tax.[1] Estate-planning attorneys, financial advisors, trust officers and certified public accountants attend innumerable seminars, some lasting up to a week, to strategize on how best to save their clients from dreaded gift and estate taxes. However, the new healthcare tax also deserves special attention because it's efficiently attacking clients' wallets now.

Estate Tax

Congress realizes that only a couple thousand estates pay federal estate tax each year. It isn't a substantial revenue raiser for the federal government because so few estates actually pay it. Past Treasury Secretary Lawrence Summers estimates that about 1 percent of the $1.2 trillion in assets inherited last year were taken in estate tax. It accounts for only about $14 billion, roughly 0.32 percent of all federal tax collections.[2] Also, many effective strategies are available to minimize or eliminate the estate tax.

It's irrelevant for most families and almost voluntary for many others. In other words, for most Americans, the federal estate tax is something akin to a great white shark. When someone swims in the ocean, the thought of being bitten by a shark may enter that person's mind, even if only fleetingly. The reality is very few Americans will ever meet a great white shark, other than on their TVs, and very few Americans will ever pay estate taxes.

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Healthcare Tax

Conversely, the applicability of the 3.8 percent healthcare tax can't be compared to the odds of meeting a great white shark or paying estate taxes. Why? The answer may surprise you. Millions of families are currently paying the new healthcare tax. Millions. And, they may well pay this tax every single year until they die. So, the healthcare tax may be better compared to living with an incurable, constant, painful backache.

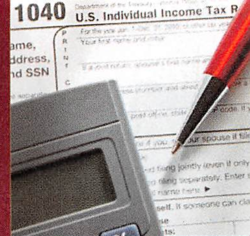
It's estimated that 3.7 million families will pay the healthcare tax in 2013. It's anticipated that 7 million families will be subject to the tax nine years from now.[3] The federal government expects that the federal estate tax will raise about $20 billion in revenue in 2013, but the healthcare tax alone will raise perhaps twice that amount in 2013.

Why will there be 7 million or more taxpayers paying the healthcare tax within the next decade? The healthcare tax thresholds aren't indexed for inflation.[4] Therefore, in a way, this new tax resembles the alternative minimum tax (AMT). The AMT, originally, was relevant to only a few of the highest earners. Over time and after inflation, the AMT also affected middle class taxpayers. Comparing the healthcare tax to the AMT offers a window into how the new tax may evolve.

Phaseouts

High-income taxpayers are familiar with the concept of phaseouts, which effectively raise their marginal income tax rates. Examples include elimination of the standard deduction, elimination of deduction for dependents and reduction in the value of itemized deductions. The removal of these deductions raises clients' marginal tax rates materially beyond those published in the Internal Revenue Code.

Similarly, the healthcare tax may be higher than advertised. In calculating the tax, not all expenses



relating to passive income are actually deductible. The fact that some of these deductions are effectively phased out makes the healthcare tax rate higher than 3.8 percent. While the exact tax rate will be different for every taxpayer, it's not unreasonable to think that the tax could effectively be 3.9 percent or higher.

An initial reaction might be, "How significant can a tenth of a percent be?" Phasing out the deductions used to calculate the healthcare tax could translate to an extra $1 billion in revenue, annually. And, that's precisely why the healthcare tax phaseouts were implemented—to quietly raise an extra billion dollars, or more, every year.

In case you feel unimpressed by a paltry billion dollars in annual taxation, think about the Foreign Account Tax Compliance Act (FATCA). All the attention and anguish over FATCA will generate less than $1 billion per year in additional revenues.[5]

Strategies to Minimize Impact

There are strategies available to minimize the impact of the healthcare tax. Those strategies include investing in municipal bonds because that income is exempt from the healthcare tax calculation. To the extent possible, taxpayers can defer income, so that they don't cross the adjusted gross income tax thresholds. Using all available retirement planning vehicles, like an individual retirement account or 401(k), can also be helpful.

Charitable remainder trusts (CRTs) are also useful, to an extent, because income payable to a beneficiary can be deferred. While CRTs aren't subject to the healthcare tax, distributions to beneficiaries are.[6] Furthermore, the CRT payments can be spread over time, allowing the CRT beneficiary to smooth income and, perhaps, minimize the impact of the healthcare tax.

Investors in real estate can spend more time in the management of their real estate holdings, so that they become "active," rather than "passive," investors.[7] Income from active participation in real estate isn't subject to the healthcare tax. Real estate investors also have the one-time option in 2013 to group their separate real estate holdings together to more easily qualify for "active" tax treatment.[8]

Life insurance contracts are another intriguing idea. Earnings inside policies accumulate income tax-free and aren't subject to the healthcare tax. Distributions from life insurance policies should often be excluded from the tax.

Irrevocable Trusts

Another critical consideration involves taxation of irrevocable non-grantor trusts (INGTs) because the income of non-grantor trusts is also subject to the healthcare tax.[9] Planning for existing INGTs can be especially challenging, since those created before 2013 were probably not done so with this new tax in mind. It's important to note that the healthcare tax isn't directly applicable to grantor trusts; however, the income from the grantor trusts may be subject to tax on the grantor's return.[10] This is significant because many clients eventually become fatigued with paying income taxes generated by the grantor trusts they created. Any client who's created a grantor trust should be aware that the revocation of grantor trust status could trigger the imposition of the healthcare tax.

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It's imperative to analyze the impact of the healthcare tax on an INGT at its creation and before its grantor trust status changes. It's now especially important to think and plan strategically for the future of irrevocable trusts.

For example, if Dad creates an irrevocable grantor trust with Mom as trustee and funds the trust with shares in the business Dad actually operates, will that trust be

obligated to pay the healthcare tax when the grantor trust status is revoked or at Dad's death? If Daughter is active in the business, perhaps the trust should provide that Daughter will act as successor trustee at Dad's death or when the trust no longer qualifies as a grantor trust. Daughter, even if she's active in the business as an individual, may also need to be active in the business in her capacity as a trustee.[11]

Why? The Internal Revenue Service has taken the conservative position that the trustee of an INGT must be active on a "regular, continuous, and substantial" basis. This standard can pose quite a challenge for any trustee and be especially burdensome for institutional trustees.

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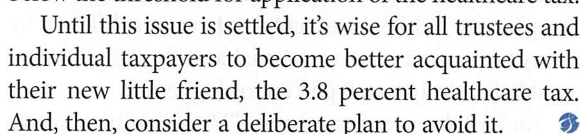
For example, imagine that Bank Z is acting as trustee of an INGT that owns all the stock of a manufacturing business. Bank Z likely isn't active in the manufacturing business. The IRS holds the position that income and/or dividends from the business to the trust are subject to the new healthcare tax. Unfortunately, designating a special trustee may not be helpful.[12] It's interesting to note that the IRS lost the *Mattie K. Carter Trust* case, in which a trustee was deemed to materially participate in operating a ranch through its agents.[13]

Challenging Position

Accordingly, the new healthcare tax has placed trustees in a challenging position. Does a trustee follow the *Carter* case and not pay the tax, or does the trustee comply with the IRS' view, possibly resulting in the imposition of the tax? Can you say "damned if you do, and damned if you don't?" One decision will make the IRS unhappy, and one decision may make trust beneficiaries unhappy. Given the uncertainty in the law, it's conceivable that trustees may simply punt the question and pay out the income to the trust beneficiaries, at least until the law in this area becomes more settled. Furthermore, making distributions to multiple beneficiaries has the benefit of spreading trust income among beneficiaries who may not be subject to the tax. That allows for at least the possibility of more of the income distributed falling below the threshold for application of the healthcare tax.

Until this issue is settled, it's wise for all trustees and individual taxpayers to become better acquainted with their new little friend, the 3.8 percent healthcare tax. And, then, consider a deliberate plan to avoid it.



Endnotes

1. This tax is imposed under 26 U.S.C.A. Section 1411 and commonly referred to as the "net investment income tax."
2. Zachary R. Mider, "How Wal-Mart's Waltons Maintain Their Billionaire Fortune," Bloomberg (Sept. 11, 2013), *www.bloomberg.com/news/2013-09-12/how-wal-mart-s-waltons-maintain-their-billionaire-fortune-taxes.html;* David Block and Scott Drenkard, "The Estate Tax: Even Worse Than Republicans Say" (Sept. 4, 2012), *http://taxfoundation.org/article/estate-tax-even-worse.*
3. Urban Institute and Brookings Institution, H.R. 9: "The Small Business Tax Cut Act," *TAX POLICY CENTER* (March 28, 2012), *http://taxpolicycenter.org/taxtopics/upload/HR9-Small-Business-Tax-Cut-Act-with-tables.pdf.*
4. $250,000 for married taxpayers who file jointly, $125,000 for married taxpayers who file separately and $200,000 for all other taxpayers. 26 U.S.C.A. Section 1411(b).
5. Florence Olsen, "Foreign Retirement Plans Seen Scrutinized in U.S. Effort: Taxes," Bloomberg (Aug. 28, 2013), *www.bloomberg.com/news/2013-08-28/foreign-retirement-plans-seen-scrutinized-in-u-s-effort-taxes.html.*
6. Kelly Greene, "Doing Well by Giving It Away," *The Wall Street Journal* (July 7, 2013), *www.wsj.com.* A charitable remainder trust (CRT) is also popular for individuals planning to move in the near future to low income tax states from their current higher income tax state. There's the potential for arbitrage in state income tax rates once the CRT payments start flowing to the CRT beneficiary.
7. 26 U.S.C. Section 1411, applying Section 469.
8. 26 U.S.C. Section 469(c)(7)(A)(i).
9. 26 U.S.C. Section 1411(a)(2). *See* Proposed Regulations Section 1.1411-2(a)(2)(iv)(B) regarding non-grantor trusts.
10. Prop. Regs. Section 1.1411-3(b)(5).
11. Internal Revenue Service Technical Advice Memorandum 134100-12 (Jan. 18, 2013).
12. Steve R. Akers, "Material Participation by Trust for Passive Loss and Medicare Tax Purposes; Technical Advice Memorandum 201317010 and Pending Tax Court Case," *www.actec.org/public/Akers_TAM_201317010_Musings.asp.*
13. *Mattie K. Carter Trust ex rel. Fortson v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003).