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## Memorandum

To	Alaska Bar - Probate Section
From	Rebecca Martin
Date	February 13, 2013
Subject	Clarification to Probate Section Meeting on February 12, 2013

The example I provided about the new 2013 3.8% medicare surtax requires some clarification and expansion.

It's helpful to be reminded that estates and trusts are not very income tax efficient since Congress compressed the income brackets for estates and trusts many years ago. In 2013, estates/trusts will hit the highest individual income tax bracket of 39.6% (yes this rate is back!) at just under \$12,000 of taxable income.

The new "medicare" surtax is imposed on the lesser of:

- (1) undistributed net investment income (NII - defined below) OR
  - (2) excess of adjusted gross income over the threshold.
- For 2013, it's expected to be about \$12,000.

This new redefined "net investment income" includes interest, dividends (qualified & non-qualified), annuities, royalties, rental income, any other passive income, and net capital gains (with some exclusions).<sup>1</sup> For the first part of the application, these are the income items you consider.

Since it is "the lesser of" "excess adjusted gross income over threshold", it could apply in estates with income as low as \$12,000 (including any retirement income). So even though, retirement accounts are not included as part of the redefined net investment income, they are part of adjusted gross income. If you have any items in an estate that are defined as net investment income, only those items (not the retirement income) will be subject to the new 3.8% tax.

For example, an estate in 2013 has \$4,000 of taxable Native corporation dividends and bank interest and \$10,000 from a retirement distribution paid directly to the estate, for total income of \$14,000. Assume no expenses and no distributions. For simplicity, also assume there is no "run" up the smaller tax brackets. This estate would pay income tax of approximately \$5,600.

<sup>1</sup> Note that the Alaska PFD was excluded from the definition of "net investment income" by Revenue Ruling 90-56.

<sup>2</sup> Calculation: base tax at 39.6% rate ( $\$14,000 * .396 = \$5,554$ )

Then, compare \$4,000 to  $(\$14,000 - \$12,000)$  or \$4,000 to \$2,000. Lesser of = \$2,000.  $\$2,000 * .038 = \$76$ . In this example, the 3.8% tax does not result in much more tax, but with larger NII items this could be significant.

### **Planning Recommendations:**

1. Elect fiscal years for anyone who dies in 2012 so that this tax does not apply. As long as your fiscal year end starts in 2012, you can use the 2012 tax rates BEFORE the new 3.8% rate applies in 2013.

As noted in the meeting, even someone who dies on December 31, 2012 can elect a November 30, 2013 fiscal year end (or shorter if estate can close sooner).

2. Making distributions can fix this issue if the heir's total income (from estate & other income like wages) will be under \$200,000 single and \$250,000 married filing jointly. For distributions, think about timing these to be in same "tax year" as large income items so that the heirs pay the income tax at their lower rates.

Practice Point - Last year after our first client meeting, my firm started providing heirs a quick one-page letter explaining that they will receive a K-1 from this estate/trust and not to file their personal tax returns until they received this information from us. Sometimes this letter is a year in advance of when they will actually receive the K-1, but it puts them on notice earlier, as many heirs are surprised when they receive a K-1 and have already incorrectly filed their personal tax returns.

3. Get the CPA on board early so (s)he can assist with income tax planning for even the small estates.
4. Consider timing of estate expenses and try to time expenses in same "tax year" as large income items.
5. If estate has liquidity for creditors, consider distributing assets to heirs instead of selling them first. Distribute assets to heirs, and then they can sell them at their lower income tax rates. Trusts could also distribute assets instead of cash to meet income distribution requirements.

Note – the income tax basis of inherited property will be very important and should be provided as part of the PR's administration.

6. Maybe some expenses, even attorney fees, should be allocated to "investment income" since the 3.8% tax is on "net", i.e. after expenses.

### **Other Sources for more Information:**

Internal Revenue Code Section 1411 & new Proposed Treasury Regulations

<http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs>

<http://www.keeblerandassociates.com/files/3.8%20Surtax%20Checklist%20for%20Trusts%20and%20Estates.pdf> (Bob Keebler's checklist)

<http://blog.aicpa.org/2012/07/estates-and-trusts-with-38-medicare-surtax.html> (Transcript of Bob Keebler's presentation with the AICPA)

<http://www.northerntrust.com/insights-research/wealth-management-research/tax-center-article/new-3point8-medicare-tax> (Very good chart at end for a complex example)

<http://www.aicpa.org/InterestAreas/PersonalFinancialPlanning/CPEAndEvents/DownloadableDocuments/KitcesReportApril2010.pdf> (A little dated since from April 2010, but still very helpful)