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Your Long-Term Capital Gains Tax Rate? It's Complicated.

After a number of years of enjoying historically low long-term capital gains rates, these rates are on the rise as a result of two major tax bills in 2010 and 2012; "Health Care and Education Tax Reconciliation Act of 2010" and the "American Taxpayer Relief Act of 2012".

The American Taxpayer Relief Act of 2012 adjusted capital gains rates (and qualified dividends) from 15% to 20% for individuals with taxable income of over $400,000 for Single Returns and $450,000 for Joint Returns as shown on the chart below. Long term capital gains can be realized from investments that are held for more than one year. Qualified dividends are those that are received from domestic corporations and qualified foreign corporations when the underlying stock has been held for 60 days or more.

Determining your basic long-term capital gains rate is relatively easy. Your taxable income is matched with your marginal tax rate and your long-term capital gains rate (and qualified dividend rate) is ascertained. For example, if you file jointly and your taxable income is $250,000, your marginal tax bracket is 33% with a long-term capital gains rate of 15%. See chart below.

Single Return				**Joint Return**			
Taxable Income		Marginal Tax Bracket	Long-Term Capital Gains & Qualified Dividend Tax Rate	Taxable Income		Marginal Tax Bracket	Long-Term Capital Gains & Qualified Dividend Tax Rate
Over	But Not Over			Over	But Not Over		
$0	$8,925	10.00%	0.00%	$0	$17,850	10.00%	0.00%
8,925	36,250	15.00%	0.00%	17,850	72,500	15.00%	0.00%
36,250	87,850	25.00%	15.00%	72,500	146,400	25.00%	15.00%
87,850	183,250	28.00%	15.00%	146,400	223,050	28.00%	15.00%
183,250	398,350	33.00%	15.00%	223,050	398,350	33.00%	15.00%
398,350	400,000	35.00%	15.00%	398,350	450,000	35.00%	15.00%
400,000		39.60%	20.00%	450,000		39.60%	20.00%

Effective January 1, 2013, a provision in the Health Care and Education Tax Reconciliation Act of 2010 imposed a surcharge called "Health Care Surcharge on Investment Income". This surcharge or resulting tax is called "Net Investment Income Tax" (NIIT). The NIIT tax will apply to individuals and undistributed net investment income of estates and trusts. Not all trusts will be subject to the surcharge. It depends upon the type of trust. For individuals the surcharge will apply when the Modified Adjusted Gross Income (MAGI) threshold of $200,000 for single returns or $250,000 for joint returns is surpassed. For trusts and estates the threshold is the dollar amount at which the highest tax bracket begins for the year (i.e. $11,950 in 2013).

The newly effective "Health Care Surcharge on Investment Income" of 3.8% takes what has been a straight forward calculation and adds a good deal of complexity. Now, your long-term capital gains rate has become a combination of the long-term capital gains rate (15% or 20%) plus the newly effective "Health Care Surcharge Tax on Investment Income" of 3.8%, although the 3.8% rate may not apply in all situations.

Before we analyze the new tax in more detail, let us establish some definitions:

Adjusted Gross Income (AGI) – gross taxable income (wages, interest, dividends, social security) minus above-the-line deductions such as alimony, self employment taxes and deductible retirement plan contributions.

Modified Adjusted Gross Income (MAGI) – for the purpose of determining what is subject to the surcharge, it is Adjusted Gross Income with adjustments for certain foreign income earned.

Net Investment Income (NII) – for these purposes, includes taxable interest and dividends, net long and short term capital gains (potentially increasing an individual's capital gains tax rates), annuity income, passive rental income, royalties and gains from the sale of a primary residence that exceed the exemption amount of $250,000 ($500,000 for a joint return). This list does not include all possible income inclusions. Distributions from pensions and other retirement accounts (IRAs, 401(k)'s, and 403(b)'s), Social Security and interest from municipal bonds are not considered to be investment income. Neither wages nor deferred compensation are included in this calculation. Amounts that have been paid or incurred to produce gross income or net gain are deductible in computing NII. These include investment interest expense (under IRC Section 163(d)(1)), investment expenses (under IRC Section 164(a)(3)) and itemized deductions subject to the 2% floor (IRC Section 67). This list of deductions is not all inclusive.

It is possible that with the combination of these two taxes, long-term capital gain rates plus the "Health Care Surcharge on Investment Income Tax" can increase an individual's long-term capital gain taxes as high as 18.8% from 15% and up to 23.8% from 20%. It is important to note that capital loss carryovers and excess investment interest from prior years are used to calculate both MAGI and NII.

Calculating the amount of the "Health Care Surcharge on Investment Income Tax" is a bit more involved than determining one's marginal tax bracket and resulting long-term capital gain rate. The first step is to determine if the individual's modified adjusted gross income (MAGI) is over the threshold amount. If it is, the surcharge is imposed upon the lesser of (1) the individual's net investment income (NII) for the year or (2) the excess of the individual's modified adjusted gross income (MAGI) over the threshold amount.

On the following page we have provided some examples of the interaction of these two provisions and the resulting taxes. Some aspects of these examples may be applicable to your situation, while others may not. As you review the examples and explanations please keep in mind that these are complex issues that require discussion with your personal tax and legal advisors. No solutions or approaches will be appropriate for every situation.

Example 1			**Joint Working**
	Combined Wages		$275,000
	Taxable Interest Income		15,000
	Annuity Income		15,000
		Total MAGI	305,000
	NII		30,000
	MAGI Over $250,000		55,000
	Applicable Tax on NII @ 3.8%		1,140
Why?	NII is less than MAGI over $250,000		

Example 2			**Joint Retired**
	Retirement Account Distributions		$120,000
	Taxable Interest Income		70,000
	Social Security		50,000
	Long-Term Capital Gain from Sale of Primary Residence after IRC Section 121 Exclusion of $500,000		400,000
		Total MAGI	640,000
	NII		470,000
	MAGI Over $250,000		390,000
	Applicable Tax on MAGI @ 3.8%		14,820
Why?	MAGI above $250,000 is less than NII		

Example 3			**Joint Retired**
	Retirement Account Distributions		$150,000
	Taxable Interest Income		57,000
	Social Security		50,000
	Net Long-Term Capital Gains		222,000
		Total MAGI	479,000
	NII		279,000
	MAGI Over $250,000		229,000
	Applicable Tax on MAGI @ 3.8%		8,702
Why?	MAGI above $250,000 is less than NII		

Example 4		Joint Working
	Combined Wages	$750,000
	Taxable Interest Income	50,000
	Net Long-Term Capital Gains	400,000
	Total MAGI	1,200,000
	NII	450,000
	MAGI Over $250,000	950,000
	Applicable Tax on NII @ 3.8%	17,100
Why?	NII is less than MAGI over $250,000	

Example 5		Joint Working
	Combined Wages	$200,000
	Taxable Interest Income	3,000
	Municipal Bond Interest Income	2,000
	Royalty Income	10,000
	Deferred Compensation	15,000
	Net Long-Term Capital Gains	3,000
	Total MAGI	231,000
	NII	16,000
	MAGI Over $250,000	0
	Applicable Tax on NII @ 3.8%	0
Why?	MAGI is not above $250,000	

Example 6		Joint Working
	Combined Wages	$345,000
	Taxable Interest Income	15,000
	Municipal Bond Interest Income	70,000
	Royalty Income	10,000
	Long-Term Capital Gain from Sale of Primary Residence after IRC Section 121 Exclusion of $500,000	400,000
	Net Long-Term Capital Gains	25,000
	Total MAGI	795,000
	NII	450,000
	MAGI Over $250,000	545,000
	Applicable Tax on NII @ 3.8%	17,100
Why?	NII is less than MAGI over $250,000	

Planning Considerations to minimize the 3.8% tax surcharge

Here are a few approaches that may assist you in your planning:

1. Consider investing in Municipal Bonds as the interest earned is not included in either NII or MAGI.

2. Contribute the maximum allowable deductible amount to Qualified Retirement Plans and IRA's to reduce your taxable income.

3. Match up Capital Gains and Losses where appropriate to avoid being pushed into the next tax bracket and as an additional benefit possibly avoid the 3.8% tax surcharge.

4. Remember that investments held more than one year are subject to taxes at long-term capital gains rates and may also be subject to the 3.8% surcharge. It is to your advantage to hold investments until they become long-term held investments. Investments realized as short-term (held 1 year or less) are subject to taxes at your marginal tax bracket and may also be subject to the 3.8% surcharge. The difference between being taxed at maximum short-term rates of 43.4%, versus the maximum long-term capital gain rate of 23.8% can be substantial.

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