You Should Know

Retirement Plan Distributions and the 3.8% Medicare Surtax

Although President Obama signed the Patient Protection and Affordable Care Act into law on March 30, 2010, the new tax provisions commonly known as the Medicare Surtax, did not take effect until January 1, 2013. Since that time, much has been written about the impact of that law on taxpayers, which effectively imposes an additional 3.8% tax on "net investment income" or when certain income thresholds are met. Thankfully, final regulations issued by the Internal Revenue Service on November 26, 2013, reassure us that distributions from our retirement plans are exempt from the definition of net investment income. But, we're not home-free yet!

For individuals, the Medicare Surtax is 3.8% of the lesser of (a) your "net investment income" or (b) your modified adjusted gross income ("MAGI") that exceeds $200,000 if you are filing your tax return as single, or $250,000 if you and your spouse are filing a joint return or if you are a surviving spouse, or $125,000 if you are married but filing separately (known as the "MAGI threshold").*

Note, that anywhere from 95 to 98% of Americans make less than $200,000 in earned income per year, depending upon the survey viewed and the year of the survey. MAGI could be higher by the time you factor in other types of income, but for most people, it probably is still less than the threshold. Therefore, most of us are more concerned with what "net investment income" consists of.

As a general rule, net investment income is primarily passive income. For a more complete description and the details of this Medicare Surtax, please request from your Guardian financial representative, our memo titled *Planning for a New Tax - The 3.8% Surtax on Unearned Income.*

Retirement Plan Distributions

Internal Revenue Code ("Code") Section 1411(c)(5) provides that the definition of net investment income does not include any distributions from a qualified plan under Code Section 401(a) (e.g., 401(k) plans, profit sharing plans, defined benefit pension plans); Code Section 403(b) (e.g., 403(b) plans common to public school teachers and employees of non-profit organizations); and Code Section 457(b) (e.g., 457(b) plans common to employees of state and local governments). That would also include Required Minimum Distributions ("RMDs") when you attain age 70 ½ years. In addition, retirement accounts established as Individual Retirement Accounts (IRAs) are also excluded. Treasury Regulation §1.1411-8 confirms that.

The regulation also addresses specific situations which are not considered to be net investment income, including:

- Rollovers to an IRA or another qualified retirement plan
- Corrective distributions to correct plans that fail certain tests
- Deemed distributions from plan loans defaulted upon or Roth IRA conversions
- Economic benefit costs of life insurance in qualified retirement plans
- Dividends on employer stock that are distributed to plan participants and deductible by the employer
- Net unrealized appreciation (NUA) attributable to employer securities that is realized on the later sale of the securities (note, however, that once employer securities are distributed from a qualified plan, the dividends paid on those securities, as well as the appreciation of the securities in excess of the NUA realized on the sale of the securities, are considered net investment income)

You Should Know

Non-Qualified and Other Retirement Plan Distributions

Retirement distributions to you from non-qualified retirement plans such as Non-Qualified Deferred Compensation Plans, Supplemental Executive Retirement Plans and 457(f) Plans are received as taxable wage income. Accordingly, they are not considered net investment income subject to the additional 3.8% Medicare Surtax.

Retirement benefits received from Social Security, unemployment compensation or veteran's benefits also are not considered to be net investment income.

The Catch

While retirement plan distributions are not considered net investment income, there is still the MAGI component of the Medicare Surtax. Distributions may impact the calculation of MAGI causing you to exceed the MAGI threshold for application of the Medicare Surtax, regardless of the amount of net investment income that you may have. Remember, that the tax is applied on the lesser of net investment income or the excess over the MAGI threshold.

Similarly, while a Roth IRA conversion may be beneficial to you because of the tax-free nature of qualified distributions from a Roth IRA, and a Roth IRA conversion is not considered to be net investment income, a Roth IRA conversion would increase MAGI, and thus may cause the application of the 3.8% Medicare Surtax. Careful analysis should be made whether to convert or not, and if so, in which year the conversion should be made.

Distributions from non-qualified retirement plans and other retirement income sources may not be considered net investment income, but may impact calculation of MAGI causing the application of the Medicare Surtax.

Conclusion

This new tax can be a rude awakening for the unwary. Careful consideration should be paid to the factors that determine modified adjusted gross income and net investment income. There are many planning opportunities that may fit your situation and still help you to minimize or avoid this Medicare surtax. Thankfully, however, we know that distributions from retirement plan accounts will not be considered net investment income subject to the surtax.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

Lanny D. Levin, CLU, ChFC
LANNY D. LEVIN AGENCY, Inc.
1751 Lake Cook Road suite 350
Deerfield, IL 60015
(847) 597-2444
lanny_levin@levinagency.com

GEAR # 2013-14388 Expiration: 12/31/2015