Johnston Investment Counsel

Trusted Fiduciaries & Fee-Only Advisors

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High-Income Individuals Face New Medicare Taxes in 2013

Two new Medicare-related taxes take effect in 2013: an additional 0.9% payroll tax on high-wage earners, and a 3.8% tax on the unearned income of high-income individuals. Here's what you need to know.

New additional Medicare payroll tax

Beginning in 2013, the employee share of the hospital insurance (HI), or Medicare, portion of the Federal Insurance Contributions Act (FICA) payroll tax will increase by 0.9% (from 1.45% to 2.35%) for high-wage earners. Will you be affected? The tax applies to the extent that your wages exceed $200,000 ($250,000 in combined wages if you're married and file a joint federal income tax return, $125,000 if you're married and file separately). So, in 2013, a single individual with wages of $230,000 will owe HI tax at a rate of 1.45% on the first $200,000 of wages, and HI tax at a rate of 2.35% on the remaining $30,000 of wages for the year.

The additional tax doesn't apply to the employer portion of the FICA payroll tax, but your employer is responsible for withholding your portion of the tax--the additional 0.9% will be withheld on any wages you receive over $200,000. Your employer won't account for any wages earned by your spouse, so if you are married, you may owe more (or less) tax than the amount that's withheld. In that case, you will pay any additional tax due (or claim a refund for taxes overpaid) on your federal income tax return for the year.

If you're self-employed, the additional 0.9% tax applies to self-employment income that exceeds the dollar amounts above (reduced, though, by any wages subject to FICA tax). If you're self-employed, you won't be able to deduct any portion of the additional tax.

New tax on investment income

Beginning in 2013, a new 3.8% Medicare contribution tax will generally be imposed on the unearned income of high-income individuals. The tax is equal to 3.8% of the lesser of:

- Your net investment income
- The amount of your modified adjusted gross income (basically, your adjusted gross income increased by an amount associated with any foreign earned income exclusion) that exceeds $200,000 ($250,000 if married filing a joint federal income tax return, $125,000 if married filing a separate return)

So, if you're single and have modified adjusted gross income of $250,000, consisting of $150,000 in earned income and $100,000 in net investment income, the 3.8% Medicare contribution tax will only apply to $50,000 of your investment income.

What is "net investment income"?

Net investment income generally includes all net income (income less any allowable associated deductions) from interest, dividends, capital gains, annuities, royalties, and rents. It also includes income from any business that's considered a passive activity, or any business that trades financial instruments or commodities.

Net investment income does not include interest on tax-exempt bonds, or any gain from the sale of a principal residence that is excluded from income. Distributions you take from a qualified retirement plan, IRA, IRC Section 457(b) deferred compensation plan, or IRC Section 403(b) retirement plan are also not included in the definition of net investment income.

Both taxes can apply

If you have high wages and investment income, you could be subject to both the 0.9% additional HI payroll tax and the 3.8% Medicare contribution tax on your investment income. So, you'll want to be sure to account for them in your overall tax plan.

See disclaimer on final page

Ways Grandparents Can Help with College Costs

Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. This rule is helpful considering that annual tuition at some private colleges is now surpassing the $40,000 mark.

College is expensive. For some fortunate students, grandparents are stepping in to help. This trend is expected to accelerate as baby boomer grandparents start gifting what could be trillions of dollars over the next few decades. Helping to finance a grandchild's college education can bring great personal satisfaction and can be a way for grandparents to minimize potential gift and estate taxes. Here are some common strategies.

Outright cash gifts

One way to contribute is to make an outright gift of cash or securities to your grandchild or his or her parent. To minimize any potential gift tax implications, you'll want to keep your gift under the annual federal gift tax exclusion amount--$13,000 for individual gifts or $26,000 for joint gifts made by both grandparents. Otherwise, a larger gift may be subject to federal gift tax and, for a gift made to a grandchild, federal generation-skipping transfer tax, which is a tax on gifts made to a person who is more than one generation below you.

An outright cash gift to your grandchild or your grandchild's parent will be considered an asset for federal financial aid purposes. Under this aid formula, students must contribute 20% of their assets each year toward college costs and parents must contribute 5.6% of their assets.

Pay tuition directly to the college

If you are considering making an outright cash gift, another option is to bypass your grandchild and pay the college directly. Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. This rule is helpful considering that annual tuition at some private colleges is now surpassing the $40,000 mark. Only tuition qualifies for this federal gift tax exemption--room and board, books, and fees aren't eligible.

Aside from the benefit of being able to make larger tax-free gifts, paying tuition directly to the college ensures that your money will be used for education purposes. However, a direct tuition payment might prompt a college to reduce any potential grant award in your grandchild's financial aid package, so make sure to ask the college about the financial aid impact of your gift.

529 college savings plan

A 529 college savings plan is a tax-advantaged savings vehicle that can be a smart way for grandparents to contribute to their grandchild's college education while paring down their own estate. Contributions to your account grow tax deferred and earnings are tax free if the money is used to pay the beneficiary's qualified education expenses (states generally follow this tax treatment as well). Funds can be used at any accredited college in the United States or abroad.

You can open a 529 account yourself and name your grandchild as beneficiary, or you can contribute to an already existing 529 account (e.g., a parent-owned 529 account).

Tip: *Under current federal financial aid rules, grandparent-owned 529 plans are not counted as a parent or student asset (only parent-owned and student-owned 529 plans count as assets), but withdrawals from a grandparent-owned 529 plan are counted as student income, which can affect student aid eligibility in the following year (withdrawals from parent-owned and student-owned 529 plans are not counted as student income).*

If you have a large sum to gift, 529 plans offer a big advantage. Under special rules unique to 529 plans, you can make a lump-sum gift of up to $65,000 ($130,000 for joint gifts) and avoid federal gift tax by making a special election to treat the gift as if it were made in equal installments over a five-year period (provided you don't make any additional gifts to the same grandchild during the five-year period). And if you happen to be the 529 account owner, you retain control over these funds. For example, if you should have unexpected medical costs, you can withdraw part or all of your lump-sum contribution (however, you will owe income tax and a 10% penalty on the earnings portion of the withdrawal). In addition, your lump-sum gift is considered removed from your estate even though you retain control over the funds as account owner (but if you were to die during the five-year period, a prorated portion of the gift would be recaptured by your estate for estate tax purposes).

Of course, you can contribute smaller, regular amounts to your grandchild's 529 account as well. If you have more than one grandchild, you can open an account for each and limit your annual contributions to each account to $13,000 or $26,000 for joint gifts. Come college time, if one grandchild gets a scholarship, you can change the beneficiary of his or her 529 account to another grandchild or you can withdraw an amount equal to the amount of the scholarship, penalty free.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing.*

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Two Social Security Strategies for Married Couples

For more information about your options and the benefit application process, contact the Social Security Administration at 800-772-1213 or visit [www.socialsecurity.gov.](http://www.socialsecurity.gov)

Every situation is unique, and these strategies may not be appropriate for all couples. When deciding when to apply for Social Security benefits, make sure to consider a number of scenarios that take into account factors such as both spouses' ages, estimated benefit entitlements, and life expectancies.

Deciding when to begin receiving Social Security benefits is a major financial issue for anyone approaching retirement because the age at which you apply for benefits will affect the amount you'll receive. If you're married, deciding when to retire can be especially complicated because you and your spouse will need to plan together. Fortunately, there are a couple of strategies that are available to married couples that you can use to boost both your Social Security retirement income and income for your surviving spouse.

File and suspend

Generally, a husband or wife is entitled to receive the higher of his or her own Social Security retirement benefit (a worker's benefit) or as much as 50% of what his or her spouse is entitled to receive at full retirement age (a spousal benefit). But here's the catch--under Social Security rules, a husband or wife who is eligible to file for spousal benefits based on his or her spouse's record cannot do so until his or her spouse begins collecting retirement benefits. However, there is an exception--someone who has reached full retirement age but who doesn't want to begin collecting retirement benefits right away may choose to file an application for retirement benefits, then immediately request to have those benefits suspended, so that his or her eligible spouse can file for spousal benefits.

The file-and-suspend strategy is most commonly used when one spouse has much lower lifetime earnings, and thus will receive a higher retirement benefit based on his or her spouse's earnings record than on his or her own earnings record. Using this strategy can potentially boost retirement income in three ways: 1) the spouse with higher earnings who has suspended his or her benefits can accrue delayed retirement credits at a rate of 8% per year (the rate for anyone born in 1943 or later) up until age 70, thereby increasing his or her retirement benefit by as much as 32%; 2) the spouse with lower earnings can immediately claim a higher (spousal) benefit; and 3) any survivor's benefit available to the lower-earning spouse will also increase because a surviving spouse generally receives a benefit equal to 100% of the monthly retirement benefit the other spouse was receiving (or was entitled to receive) at the time of his or her death.

Here's a hypothetical example. Leslie is about to reach her full retirement age of 66, but she wants to postpone filing for Social Security benefits so that she can increase her monthly retirement benefit from $2,000 at full retirement age to $2,640 at age 70 (32% more). However, her husband Lou (who has had substantially lower lifetime earnings) wants to retire in a few months at his full retirement age (also 66). He will be eligible for a higher monthly spousal benefit based on Leslie's work record than on his own--$1,000 vs. $700. So that Lou can receive the higher spousal benefit as soon as he retires, Leslie files an application for benefits, but immediately suspends it. Leslie can then earn delayed retirement credits, resulting in a higher retirement benefit for her at age 70 and a higher widower's benefit for Lou in the event of her death.

File for one benefit, then the other

Another strategy that can be used to increase household income for retirees is to have one spouse file for spousal benefits first, then switch to his or her own higher retirement benefit later.

Once a spouse reaches full retirement age and is eligible for a spousal benefit based on his or her spouse's earnings record and a retirement benefit based on his or her own earnings record, he or she can choose to file a restricted application for spousal benefits, then delay applying for retirement benefits on his or her own earnings record (up until age 70) in order to earn delayed retirement credits. This may help to maximize survivor's income as well as retirement income, because the surviving spouse will be eligible for the greater of his or her own benefit or 100% of the spouse's benefit.

This strategy can be used in a variety of scenarios, but here's one hypothetical example that illustrates how it might be used when both spouses have substantial earnings but don't want to postpone applying for benefits altogether. Liz files for her Social Security retirement benefit of $2,400 per month at age 66 (based on her own earnings record), but her husband Tim wants to wait until age 70 to file. At age 66 (his full retirement age) Tim applies for spousal benefits based on Liz's earnings record (Liz has already filed for benefits) and receives 50% of Liz's benefit amount ($1,200 per month). He then delays applying for benefits based on his own earnings record ($2,100 per month at full retirement age) so that he can earn delayed retirement credits. At age 70, Tim switches from collecting a spousal benefit to his own larger worker's retirement benefit of $2,772 per month (32% higher than at age 66). This not only increases Liz and Tim's household income but also enables Liz to receive a larger survivor's benefit in the event of Tim's death.

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As a business owner, what should I know about using temporary workers?

Generally, temporary work is any work that is not intended to be permanent or long term. Temporary work can be full- or part-time.

Use of temporary workers (sometimes referred to as temps) may provide you with some flexibility to handle employee absences due to illness, vacation, or maternity leave. They may also help you handle special projects, busy times, or seasonal work.

In a slow economy, temporary workers might be used until permanent needs become more certain. The temporary employee can be more easily let go if need be.

Temporary workers can be hired directly or through a temporary employment agency. Temporary workers you hire directly, even if part-time, are generally treated the same as full-time workers and may be entitled to employee benefits through you. For example, a worker who completes 1,000 hours of service in a year may be eligible to participate in your retirement plan.

On the other hand, a temporary employee hired through a temporary employment agency works for the employment agency, not for you. The employment agency is generally responsible for the temporary employee's benefits, if any. The hourly wage rate you pay to the agency may be higher as a result.

The temporary employment agency can save you time and effort by finding and screening potential employees so that you don't have to. They may have a pool of temporary employees available at any time and at a moment's notice.

However, you may need to break in or train a temporary employee each time you get one from the employment agency. To minimize this, you may request that the employment agency send a temporary employee who has already worked for you before.

Sometimes a temporary employee may become a permanent employee. If an employee was hired through a temporary employment agency, depending on the contract with the employment agency, you may need to pay a fee to the agency if you permanently hire the temporary employee.

As a business owner, what should I know about using remote employees?

Interest in the use of remote employees has greatly increased along with growth in the number of service jobs and developments in technology that enable some workers to work almost anywhere. A remote employee is someone who works away from the office, often at home, part or all of the time. You might be able to use a remote employee in your business if the employee does not need to be at a specific location in order to do the work required.

You may be able to increase the talent pool available to your business by hiring an employee who is not local and permitting the employee to stay where he or she is and work remotely. Even local employees may see an advantage to working remotely at least part of the time.

Remote employment can be incorporated as part of flexible scheduling. An employee might come into the office one or two days a week, and work remotely the remainder of the week. Remote employment can be especially advantageous where the employee would otherwise face a long commute to work, or the employee has to balance work with the occasional care or transport of young children or elderly parents.

If you hire an employee who works remotely in another state, remember that there are tax consequences. If the employee works almost entirely in the other state, the employee will usually pay income tax in the other state. If the employee splits time between the two states (for example, works one day a week in state A, and the other four days in state B), the employee may pay income taxes in both states.

As the employer, you will usually need to create an account with the state, and possibly local, taxing authorities in the other state, and withhold income taxes from the remote employee's wages and pay them to such tax agencies. As the employer, you may also need to pay unemployment insurance to the other state. A payroll service, accountant, or attorney can help you determine what your obligations are and how to meet them.

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