

SUMMER 2011

## Inside

Estate Tax Exemption  
Portability: What Is  
It and Why Does It  
Matter? 2

People News 3

Expanded 1099 Filing  
Repealed 3

Rate Changes of  
Note 4

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## New Medicare Tax on the Horizon

As this is being written, the administration and Congress are debating the merits and wisdom of enacting tax increases to help deal with our country's financial deficits. Most of the tax increase rhetoric has focused on "tax loopholes" used by the businesses and "the rich" and on tax rates applicable to "the rich." Receiving little, if any, attention is the fact that last year's comprehensive healthcare reform legislation includes a significant increased tax burden on the targeted individuals in the form of a 3.8% Medicare tax on *unearned income* for those whose income exceeds certain thresholds. This new tax becomes effective in 2013.

Here's how the new tax works:

- It applies to individuals, estates, and trusts, not to C corporations or pass-through entities.
- The individual thresholds are MAGI (adjusted gross income modified for persons with foreign earned income) exceeding these amounts:
 

Single individual	\$200,000
Married couple filing jointly	\$250,000
Married couple filing separately	\$125,000

These thresholds are not adjusted for inflation.

- The tax applies to the lesser of:
  1. "net investment income," or
  2. the excess of MAGI over the threshold.
- "Net investment income" includes taxable interest, dividends, annuities, royalties, and rents (except when derived in the ordinary course of a business), less allowable deductions. It also includes passive activity income and gains from property dispositions other than from property held in an active business.
- Noteworthy exclusions from "net investment income" are tax-exempt interest and retirement plan distributions (including those from IRAs).
- The rate applied to the taxable amount is 3.8%.

Here are a couple of examples that may help you understand how this new tax will apply:

**Example 1:** Bob, a single retiree, has retirement income (including the taxable part of his Social Security benefits) of \$150,000, taxable interest and dividends of \$100,000, and tax-exempt interest of \$50,000. Bob's MAGI (\$250,000) exceeds his applicable threshold (\$200,000) by \$50,000. Because this is less than his net investment income of \$100,000, only \$50,000 of his net investment income is subject to the new 3.8% tax. His additional Medicare tax is \$1,900. The other \$50,000 of his net investment income, because it falls within the threshold amount, is not subject to the additional Medicare tax.

**Example 2:** Andy and Ann, a married couple who file a joint return, have W-2 income of \$300,000, dividends of \$25,000, net capital gains from stock sales of \$50,000, a gain from selling their vacation home of \$100,000, and income from a partnership which is a passive activity of \$25,000. Because their earned income of \$300,000 by itself exceeds the threshold, all of their "net investment income" -- in this case, all of their other income items, totaling \$200,000 -- is subject to the 3.8% additional Medicare tax, increasing their taxes by

continued on page 2



New Medicare Tax on the Horizon,  
continued from page 1

\$7,600.

In planning for the new tax, consider that if the tax is expected to apply to you, and if you have fixed income investments, tax-exempt bonds will be relatively more popular due to the increased tax on taxable interest. Consider also the potential benefit of tax-exempt interest not being included in MAGI.

Also regarding planning, realizing gains prior to 2013 may be advantageous, perhaps even in some cases by selling securities or other nonbusiness assets prior to 2013 and buying them back immediately to establish a new cost basis immediately (after giving due consideration to transaction costs). For those who would bear the full impact of the new Medicare tax, the top marginal federal rate on long-term capital gains after next year is scheduled to be 23.8% vs. 15% through next year, a 59% increase in federal tax on such gains.

Finally, recognize that the new Medicare tax's effective date has not yet arrived and Congress has shown an increasing tendency to modify or delay scheduled tax law changes. Don't be overly surprised if that happens in this case.

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## Estate Tax Exemption Portability: What Is It and Why Does It Matter?

Traditional estate planning for many married couples concerned about estate taxes has involved each spouse owning enough assets that could be left in a manner that would have been (1) taxable upon the first spouse's death, but for the available estate tax exemption, and (2) nontaxable in the surviving spouse's death. A "credit shelter" or "bypass" trust has been the commonly-used vehicle to accomplish this.

Considering the current \$5 million per person exemption (scheduled to return to \$1 million in 2013), a married couple who desire to maximize their heirs' inheritance and have \$5-10 million of net assets may want to balance their assets to increase the chances of not wasting either's exemption. For example, if a couple has \$8 million, including \$6 million in H's name and \$2 million in W's name, \$3 million of exemption could be lost if W predeceases H, even if her plan involved her \$2 million being used to fund a credit-shelter trust. Assuming no changes in asset values or exemption when H subsequently dies, \$1 million of his \$6 million would be taxable in his estate. If H had transferred \$1 million of his \$6 million of assets to W during her life (a nontaxable gift), and she then predeceased H, her \$3 million could have been used to fund a credit shelter trust, and H's \$5 million dollar exemption would fully shelter federal estate tax in his estate (consisting of \$5 million of assets after the gift to W).

In the absence of a "balancing transfer" to W, if H's \$6 million grows in value between W's death and his, more tax will be due, and the imbalance in H's and W's assets would be more costly to their heirs.

If a married couple's net assets are at least the amount of the combined exemptions, \$10 million currently, the greatest tax efficiency is likely to result from the spouses having at least \$5 million in each name.

Note that some assets that may be included in a taxable estate, such as assets jointly-owned with survivorship and certain trust assets, may not be able to be transferred using a credit-shelter trust. And certain other assets, such as IRA and other retirement plan accounts, may not, for other tax reasons, be good candidates for funding credit-shelter trusts, and they cannot be transferred between spouses during life, sometimes hindering the process of optimally balancing married couples' assets.

One of many welcome surprises in last year's December tax legislation was the introduction of the concept of "portability" of unused exemption at the death of the first spouse. Provided an election is properly made at the first spouse's death, the surviving spouse can use his or her deceased spouse's unused exemption to offset future estate or gift taxes.

For a variety of reasons, we continue to believe traditional planning is preferable to reliance on portability. Portability, though, may serve a useful purpose where optimal asset balancing between spouses has not been done.

As of now, portability is available only through 2012, but some commentators believe it is likely to continue.

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## People News

We are very pleased to have had several talented client service and support team members join us recently. They are:

**Chris Hockaday**, a CPA who earned his Business Administration degree at Colorado State University. Chris has over five years of experience in public accounting, has relocated from Champaign, Illinois, and has joined our Assurance Services Group.

**David Caudill, Jamie Lee, and Matthew Seuling**, who are beginning their public accounting careers with our firm. David earned his Accounting degree at Morehead State University; Jamie earned her undergraduate degree in Business Administration from Ewha Woman's University in Seoul, Republic of Korea and graduate degrees in Accounting and in Taxation from State University of New York; and Matthew, after earning a Secondary Education degree in Australia, obtained his Accounting degree from Indiana University Southeast. Jamie has successfully completed the CPA examination.

**Jodi Christopher**, a Document Processing Specialist. Jodi has over 15 years of experience providing a variety of office services to businesses.

**Matthew Laguna**, who has joined our Technology Consulting Team and primarily is focusing on network architecture, network security, and Voice-Over-IP phone solutions. In addition to experience with companies in the U.S., Matt has provided network and communications consulting services for U.S. military contractors in war zones in Iraq and Afghanistan.

**Melanie Wales**, a CPA who earned her Accounting degree at Purdue University in 2006 and had been working with an Indianapolis firm since then. Melanie has joined our Assurance Services Group.

**Stuart Geiger**, another addition to our Assurance Services Group and a Business Administration graduate of the University of Louisville. Stuart has over 11 years of public and private accounting experience.

**Thom Greene**, a 2005 Centre College graduate with his degree in Economics. Thom is an IT professional who works in our internal technology area.

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We also recognize the following activities and accomplishments of our team members:

**Adam Shewmaker** is serving on the Executive Leadership Committee for the Leukemia and Lymphoma Society in Louisville, and he is participating in the 2011 Louisville Healthcare Fellows program.

**Allison Carter** is serving on the board and as treasurer of Living Arts and Science Center in Lexington.

**Allison Carter** and **Melissa Coombs** co-authored "Reporting Requirements for Not-for-Profit Organizations" for *The Kentucky CPA Journal*, and **Allison** authored "Maintaining Exempt Status" for the same publication.

**Hunter Stout** was nominated as a "Hero" as part of the Bluegrass Chapter of the American Red Cross's Fayette County Heroes Campaign. Hunter's nomination was based on his leadership role in our firm's Adopt-a-School program with Breckinridge Elementary School in Lexington.

**Lance Mann** and **Melissa Coombs** presented "Financial Responsibilities: What a Board Member Needs to Know" at Louisville's Center for Nonprofit Excellence's *Get on Board* series.

**Leigh McKee** co-authored the first edition of *Equine Sales & Use Tax Review*, co-produced by our firm.

**Lisa Wilson** has been appointed to the board of Kentucky Pink Connection.

### Expanded 1099 Filing Repealed

Our last newsletter issue included an article titled: "Will Congress Repeal Enhanced 1099 Reporting?" Well, it now has. The substantial expansions of 1099 filing requirements enacted in 2010 have been repealed before becoming effective. Businesses still are required to issue 1099s for payments of \$600 or more to service providers, and the exception for payments made to corporations remains in place. Landlords whose rental activities constitute a trade or business are still obligated to report payments to service providers of \$600 or more.

While businesses and landlords were released from the additional 1099 reporting requirements, increased penalties remain, making noncompliance potentially expensive.

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Stephanie Huntsman (shuntsman@ddafcpa.com)

*continued on page 4*



People News continued from page 3

**Martha Jones** has been elected to the Saint Joseph Healthcare Foundation board.

**Melissa Coombs** is succeeding **Lara Rhodes** in chairing the Kentucky Society of CPAs' Accounting Career Opportunities Committee.

**Missy DeArk** has been selected to serve as a board member of the Greater Clark County (IN) Schools Educational Foundation.

**Missy DeArk, John Herring,** and **David Parks** presented in Louisville at the Annual AAML/LBA Family Law Seminar on "Valuation of Stock Options" and "Valuation Tips for Attorneys."

**Pam Crouch** is serving as a board member and as treasurer of Commonwealth Soccer Club and has been elected to the Site Base Decision Making Council at Tates Creek High School in Lexington.

**Simon Keemer** was named Outstanding Committee Chairperson by the Kentucky Society of CPAs. He chaired the Society's Continuing Professional Education Committee.

## Rate Changes of Note

**The Federal Unemployment Tax rate (FUTA)**, which had been 0.8%, dropped to 0.6% after June 30, 2011.

Due to rising gasoline costs, the IRS increased the optional **standard mileage rate** as of July 1, 2011 to 55.5 cents per business use mile from 51 cents.

The matters discussed in these articles provide general information only. You should consult with us about your specific situation before undertaking action based on such general information.

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