

3.8%

Tips to Minimize the Medicare 3.8% Tax

Jason Print, CFP
Partner and Senior Wealth Advisor



How do we minimize the Medicare 3.8% tax? That is a question that many experts in our industry are working to find the answers. Steve Parrish, with more than 35 years experience as a wealth advisor and financial planner contributed the following strategies to Forbes Entrepreneurs in August. Parrish wrote "Despite the complexity of this 3.8% surtax, there are two basic ways to "burp" income to reduce or avoid this tax: 1) reduce income (MAGI) below the threshold, or 2) reduce the amount of NII that is subject to the tax.



Reduce Your Overall Income

- If you are an employee of your company, you can direct some of your earned income to a **qualified retirement plan** to reduce your taxable income. You can: 1) increase your contribution to your 401(k) plan, 2) add dollars to the plan as part of a catch-up contribution (if you're age 50 or older) or 3) create a new qualified plan. These pre-tax contributions lower the amount of wages that are counted in MAGI.

- Similarly, you can direct wages to a **nonqualified deferred compensation plan**. This too reduces current taxable compensation. A caveat: this must be set up in advance, and if your business is a "flow through" tax entity (for example an S Corp or LLC), some of what you defer from wages will appear in your owner share of earnings. MAGI would include those earnings.

- Spread out capital gains** from a sale of company stock or other business assets. With some tax modeling, it may be possible to calculate how to spread out payments such that you keep income below the threshold. In the example above where the couple's MAGI is projected to

be \$300,000, they might arrange a pending sale so that they are spreading out capital gains over future years. They could design the sale such that their income in the current year is now less than \$250,000; and, thereby they avoid having to worry about the tax.

- Invest in tax free or tax deferred instruments.** The income derived from financial instruments can be the culprit in driving taxable income over the MAGI threshold. If the income, however, is coming from municipal bonds, deferred annuities or the growth of cash value in a life insurance policy, such income is potentially not subject to current inclusion in income.

Reduce Your Net Investment Income

Even if your income is above the MAGI threshold, the 3.8% tax can be lowered or eliminated by reducing the amount that is characterized as net investment income.

- Re-characterize income.** Working with tax advisors, you may be able to re-characterize some forms of income. For example, with proper planning, what otherwise would be characterized as passive income from a business (and therefore treated as NII), may be structured to constitute wages (and not subject to the 3.8% tax)."

This would primarily pertain to small business owners; having income classified as wages may bring in other tax issues. However, it's worth asking your tax advisor.

Source: Forbes website