

# Increased Medicare Tax on High-Income Taxpayers and Unearned Income

For tax years beginning in 2013, an increased Medicare tax will apply to high income taxpayers and a new Medicare contribution tax will apply to investment income.

Originally published in *the AICPA Tax Insider Newsletter*  
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Healthcare reform enacted by the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act, will be partially financed by an increase in the Medicare Hospital Insurance ("HI") tax on employees and self employed individuals and the imposition of a 3.8 percent Medicare contribution tax on net investment income, both beginning in 2013.

## **Background**

The Federal Insurance Contribution Act (FICA) imposes two taxes on wages of employees, one the old age, survivors and disability insurance (OASDI) tax and the other the Medicare Hospital Insurance (HI) tax. The current HI tax rate is 2.9 percent with employers and employees each paying 1.45 percent. Since 1993, the HI tax has not been capped and each dollar of wages and self employment income has been subject to the HI tax.

### **Increase in HI Tax for High-Income Taxpayers**

Beginning in 2013, the HI tax imposed upon employees, but not on employers, on wages in excess of the applicable threshold amount will be increased by 0.9 percent. The additional HI tax does not apply to corporations, estate or trusts. The threshold amount is \$250,000 for taxpayers filing joint returns and for surviving spouses, \$125,000 for a married taxpayer filing a separate return and \$200,000 for a single taxpayer filing an individual return. These threshold amounts are not indexed for inflation.

The employer is required to withhold the additional HI tax on only the wages of the employee in excess of \$200,000 and is liable for the tax if it fails to withhold. In so doing, the employer must disregard the wages of the employee's spouse. As a result, the employer must withhold the additional HI tax on the employee's wages in excess of \$200,000, even though the additional HI tax may not apply as a result of the combined wages of the employee and the employee's spouse being less than \$250,000. The opposite may occur where the wages of each the employee and the employee's spouse are less than \$200,000, but combined the wages are in excess of the \$250,000. Under that situation the employer of each the employee and the employee's spouse is not obligated to withhold the additional HI tax.

The employee is liable for any additional HI tax to the extent that it is not withheld by the employer, which would be the case in both examples above. The additional HI tax for which the employee is liable is to be taken into consideration by the employee in making estimated tax payments.

### **Self-Employment Contributions Act (SECA)**

There are parallel provisions beginning in 2013 imposing the additional 0.9 percent HI tax on self employment income in excess of the threshold amounts. In addition, the income-tax deduction for one half of the self-employment taxes is to be computed without regard to the additional HI tax.

### **Medicare Contribution Tax on Net Investment Income**

The Reconciliation Act imposes a 3.8 percent Medicare contribution tax on individuals, estates and trusts on net investment income over certain threshold amounts. The tax does not apply to

nonresident aliens, trusts all of the unexpired interests in which are devoted to charitable purposes, trusts that are exempt from tax under Section 501 and charitable remainder trusts that are exempt from tax.

For individuals the Medicare contribution tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income (MAGI) over the applicable threshold amount. The threshold amount is \$250,000 for taxpayers filing joint returns or surviving spouses, \$125,000 for separate returns of married individuals and \$200,000 for individual returns. For estates and trusts, the threshold amount is the dollar amount at which the highest income tax bracket begins for such taxable year. The MAGI is adjusted gross income increased by the amount excluded from income as foreign earned income, net of deductions and exclusions disallowed with respect to the foreign earned income.

For these purposes "investment income" is gross income from dividends, annuities, royalties and rents (other than income derived from any trade or business to which the Medicare tax does not apply); gross income from any trade or business that either is a passive activity with respect to the taxpayer or is from trading in financial instruments or commodities; net gain (to the extent taken into account in computing taxable income) from the disposition of property other than property held in a trade or business to which the tax does not apply. Properly allocable deductions can be deducted from such gross income or net gain in determining net investment income.

According to the Joint Committee Technical Explanation investment income "does not include items, such as interest on tax exempt bonds, veterans' benefits and excluded gain from the sale of a principal residence that are excluded from gross income under the income tax." In addition, net investment income does not include any distribution from a qualified plan or IRA or any income that is subject to the self employment tax. In determining net investment income, no distinction is made between qualified and ordinary dividends and between short-term and long-term capital gains.

With respect to trade or business income from partnerships, LLCs and Subchapter S corporations, the income attributed to the taxpayer will not be excluded from investment income unless the taxpayer materially participates in the activities of the trade or business in accordance with the passive activity rules. Investment income from the investment of working capital of a trade or business is subject to the same general rules as under the passive activity rules.

Gain or loss from the disposition of a partnership interest or stock in a Subchapter S corporation, where the taxpayer does not actively participate in the trade or business, will be investment income only to the extent of the net gain or loss that would be taken into account by the taxpayer if the entity sold all of its property for fair market value immediately before the disposition. Any gain or loss in excess of such amount will not be investment income subject to the Medicare contribution tax.

The 3.8 percent Medicare contribution tax also applies to estates and trusts. In computing the amount of net investment income the threshold amount is the dollar amount at which the highest estate and trust income tax bracket starts, e.g. \$11,200 for 2010. For a trust or estate, the Medicare contribution

tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over the threshold amount for trusts and estates.

The Medicare contribution tax is subject to the individual estimated tax provisions and is not deductible in computing any other income tax imposed by the Code. Also the Medicare contribution tax will be treated as a tax for purposes of computing the penalty for underpayment of the estimated tax.

### **Conclusion**

It is too early to determine what planning taxpayers will engage in to avoid the additional Medicare taxes. Among the initial suggestions are converting investments into municipal bond investments and the use of Subchapter S corporations to conduct active trades or businesses while paying the active shareholder little or no salary. This later technique already is under scrutiny by the IRS in connection with its efforts to narrow the "tax gap" attributable to the underpayment of employment taxes.

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