



COMING SOON FOR 2013 – THE NEW MEDICARE TAXES

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March 23, 2010, June 28, 2012 and January 1, 2013. What is the significance of these three dates – past, present and future?

On March 23, 2010 President Obama signed the Patient Protection and Affordable Care Act. On June 28, 2012, the Supreme Court upheld the “individual mandate,” which requires most Americans to maintain “minimum essential” health care coverage. On January 1, 2013, three Medicare related taxes included in the Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 come into effect – the additional 0.9% Medicare tax on wages for high-income wage earners, the additional 0.9% Medicare tax on high-income self-employed individuals, and the new 3.8% unearned income Medicare contribution tax on high-income taxpayers.

January 1, 2013 may have seemed distant in the Spring of 2010, but it is now less than six months away and the reality of the additional and new Medicare related taxes is looming. What can you do to plan for these taxes? The first step is to understand how they will affect you.

Additional Medicare Tax

Employment taxes have long been a part of our tax experience – the tax on employers and the matching tax on employees for old-age, survivors, and disability insurance (OASDI) and hospital insurance (HI). What is new for 2013 is an additional HI tax of 0.9% on the wages of individuals in excess of a threshold amount. The additional HI tax brings the total employee and employer HI taxes to 3.8% (1.45% employee share, 1.45% employer share, and new 0.9% additional employee share). The threshold wage level for the additional HI tax is \$250,000 for married persons filing a joint return, \$125,000 for married persons filing separately, and \$200,000 for all others. These thresholds are not inflation-adjusted. The additional tax will be withheld by employers on employee wages in excess of \$200,000, without regard to filing status or wages received by an employee’s spouse. Employees will be required to pay amounts not withheld by their employer and employees whose additional tax is not covered by withholding may need to include the additional tax in their estimated tax payments and avoid estimated tax under payment penalties.

Additional Self-Employment Medicare Tax

If you are self-employed the hospital insurance portion of your self-employment tax on self-employment income in excess of a threshold amount will be subject to an additional 0.9% tax. This brings the total self employment tax to 3.8% (2.9% “base” and new 0.9% additional). The threshold is self-employment income in excess of \$250,000 for a married couple filing jointly, \$125,000 for a married couple filing separately, and \$200,000 for all others, with no inflation adjustment.

New Unearned Income Medicare Contribution Tax

Beginning in 2013 the net investment income of high-income taxpayers will be subject to an entirely new 3.8% unearned Medicare contribution tax. Why 3.8%? This is the total of the base and additional hospital insurance taxes on wages and self-employment income of high-income earners.

The new 3.8% tax will apply to “net investment income” of high-income individuals, estates and trusts. Whereas the thresholds for the additional taxes on wages and self-employment income are based on wage and self-employment income levels, the threshold for individuals is based on “modified” adjusted gross income (MAGI) and the threshold for estates and trusts is based on adjusted gross income.

The tax for individuals may be expressed as a formula as follows:

$$\text{Tax} = 3.8\% \times (\text{lesser of (i) net investment income and (ii) modified adjusted gross income less threshold amount})$$

Similarly, the tax for estates and trusts may be expressed as a formula as follows:

$$\text{Tax} = 3.8\% \times (\text{lesser of (i) undistributed net investment income and (ii) adjusted gross income less the dollar amount at which the highest tax bracket applies for the estate or trust})$$

There are two circumstances where the additional 3.8% tax will *not* apply. First, when an individual’s modified adjusted gross income does not exceed the threshold amount or an estate or trust’s adjusted gross income does not exceed the marginal tax bracket threshold. Second, when an individual taxpayer does not have “net investment income” or an estate or trust does not have “undistributed net investment income.”

Let’s begin with the first circumstance. For individual taxpayers, modified adjusted gross income is adjusted gross income (which appears at the bottom of page 1 of Form 1040) plus, in the case of a U.S. citizen or resident living abroad, any foreign earned income and housing costs that are otherwise excluded from adjusted gross income. The threshold modified adjusted gross income amount is \$250,000 for married persons filing jointly or a surviving spouse, \$125,000 for married persons filing separately, and \$200,000 for all others, with no inflation adjustment.

The question then becomes, what is included in the adjusted gross income portion of modified adjusted gross income? This is not a new tax concept, it is all of the items of income that are reported on page 1 of Form 1040 – wages, taxable interest, dividends, capital gain, traditional individual retirement account distributions (IRA), rent, etc., reduced by limited expenses such as moving expenses, but not by itemized deductions that are reported on Schedule A. Significantly, modified adjusted gross income does *not* include tax exempt interest, distributions from Roth IRAs, or the excluded gain from the sale of a principal residence (\$500,000 for married taxpayers filing jointly and \$250,000 for other taxpayers).

Planning pointer: When considering whether to invest in taxable or tax-exempt obligations, whether to convert a traditional IRA to a Roth IRA, or whether to make contributions to a traditional IRA or a Roth IRA, take the new Medicare tax on unearned income into account.

Planning pointer: If you sell your principal residence, unless the gain exceeds the exclusion amount for the gain from the sale of a principal residence, the gain alone should not result in additional Medicare tax on unearned income.

For estates and trusts, the threshold is much lower. It is the level at which the marginal income tax rate applies to the estate or trust. This is \$11,650 for 2012 and is expected to be slightly higher for 2013.

Planning pointer: Because the threshold for estates and trusts is lower than for individuals, trusts and estates may deduct the distributable net income paid to beneficiaries and beneficiaries pay tax on this income, in some circumstances income that would be subject to the 3.8% tax if accumulated by a trust will not be subject to the tax if distributed to a beneficiary. This may be a consideration in planning for distributions from a trust.

If your modified adjusted gross income exceeds the threshold level that applies to you, the next step will be to determine your “net investment income.” This is investment income reduced by deductions “properly allocable” to that income. Regulations that further clarify the scope of net investment income are expected. What is clear from the language of the statute and the official explanations of the statute is that net investment income includes:

- Gross income from interest, dividends, annuities, royalties and rents (unless from a trade or business);
- Net gain (to the extent taken into account in computing taxable income) from the disposition of property (other than certain active trade or business property); and
- Gross income from a passive trade or business or trading financial instruments or commodities.

Broadly speaking, if an item of income is subject to the additional 0.9% tax on wages or the 0.9% tax on self-employment income, it should not also be subject to the 3.8% tax on unearned income. Furthermore, gross income for this purpose does not include items such as interest on tax-exempt bonds, veterans’ benefits, and excluded gain from the sale of a principal residence. In addition, retirement plan distributions – distributions from qualified pension, profit sharing and stock bonus plans, qualified employee annuity plans, individual retirement accounts, Roth IRAs and government and tax-exempt organization deferred compensation plans - are not included in net investment income..

	Modified Adjusted Gross Income or Adjusted Gross Income	Net Investment Income
Taxable interest, dividends, annuities, royalties, rents (non-active business)	Include	Include
Tax exempt interest	Exclude	Exclude
Capital gains generally	Include	Include
Capital gain on sale of principal residence excluded from computation of ordinary income tax	Exclude	Exclude
Distributions from traditional qualified retirement accounts (IRA, 401(k), etc.)	Include	Exclude
Distributions from Roth IRAs and Roth 401(k)s	Exclude	Exclude
Income from “passive” trade or business or trading financial instrument or commodities	Include	Include
Income from an active trade or business	Include	Exclude

In summary, the “character” of income is important for purposes of determining whether you exceed the applicable threshold and, if so, whether you have net investment income that will be subject to the new 3.8% tax. Consider the following examples:

Example: Sam and Elizabeth file a joint federal income tax return. In 2013 they receive \$50,000 of taxable interest income, \$50,000 of tax-exempt interest income, and a distribution of \$240,000 from their traditional IRA. They also sell their home, which they purchased for \$500,000, for \$1,000,000. Their MAGI is \$290,000 (\$50,000 taxable interest income plus \$240,000 IRA distribution). The tax-exempt interest is not included in their MAGI and the \$500,000 gain on their residence is excluded under the long-standing exclusion from taxable income of gain up to \$500,000 on the sale of a principal residence for married persons filing jointly. Their net investment income is \$50,000, and the excess of their MAGI over the threshold amount is \$40,000 (\$290,000 less \$250,000). Their 2013 unearned Medicare contribution tax is \$1,520 (3.8% x \$40,000).

Example: If Sam and Elizabeth had previously converted their traditional IRA to a Roth IRA and received a \$240,000 distribution from their Roth IRA in 2013 instead of from a traditional IRA, their MAGI will be only \$50,000 (the taxable interest income) and they will owe no additional Medicare contribution tax because they will not reach the \$250,000 threshold.

Example: If Sam and Elizabeth sold their vacation home instead of their primary residence, the gain on the sale of their vacation home will be included in their MAGI (\$790,000) and in their net investment income (\$550,000). Their 2013 unearned Medicare contribution tax in this circumstance is \$20,250 (3.8% x (\$790,000 MAGI - \$250,000 threshold)).

January 1, 2013 is fast approaching. Although there has been much discussion about extending the Bush-era income tax cuts for some period of time – possible a year - at least for middle income taxpayers, to date there has not been any bipartisan movement toward deferral or repeal of the Medicare related taxes. Now is the time to begin planning for these taxes.

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