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New Medicare Taxes

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We have received quite a number of recent inquiries concerning the proper application of and appropriate planning for what are commonly referred to as the new "Medicare Taxes" effective for the first time during the current year of 2013. Because there is so much confusion concerning the parameters and application of these new tax provisions, and because the new rules may require special employer withholding obligations, you might be interested to note some of the most relevant and distinguishing highlights about these new taxes.

Although the new Medicare taxes were clearly enacted as measures for financing national health care reform, there are actually two (2) separate and distinct components of the so-called Medicare tax which are often confused -- one a new 0.9% surtax on earnings, and the other a new 3.8% tax on investment income.

SURTAX ON EARNINGS FROM EMPLOYMENT

- In addition to the regular income tax, the alternative minimum tax ("AMT") and state-level income taxes, a new **0.9%** surtax is now imposed on earnings from employment and self-employment.
- The new 0.9% surtax is imposed only on the wages and self-employment earnings *(not the investment income)* of individual workers (not corporations, trusts or estates).
- The new 0.9% surtax is imposed only on the excess wages and earnings of individual taxpayers above certain thresholds based on their applicable tax return filing status – i.e., in excess of thresholds of $250,000 for married couples filing jointly; $125,000 for a married person filing separately; and $200,000 for all other filers.
- Ultimately, alongside the 6.2% Social Security tax imposed on wages up to a fixed wage base (currently $113,700), the Medicare tax now effectively applies a 1.45% tax rate on the first $200,000 of wages (or on the first $250,000 of wages on the return of a married couple filing jointly; and the first $125,000 of wages on a return of a married person filing separately), and an effective 2.35% rate (1.45% plus 0.9%) on all wages above those thresholds.
- Although the surtax is administered as part of the Medicare tax, this new 0.9% surtax is imposed only on the earnings of the worker -- there is no matching surtax imposed on the employer.

- Employers must withhold the 0.9% surtax *only* if and when an employee's wages exceed a threshold of $200,000 – without regard to the earnings of the worker's spouse. Consequently, where the wages of each spouse in a two-earner married couple do not separately trigger employer withholding, the couple may nevertheless have to request additional withholding and/or calculate and pay estimated taxes to account for the imposition of the new 0.9% surtax on their combined wages and earnings as they will appear on their tax return(s). Employers cannot unilaterally elect to over withhold to account for the new 0.9% surtax unless directed to do so by the employee.
- Self-employed persons must clearly calculate and pay estimated taxes to account for the imposition of the new 0.9% surtax. Further, distinct from the treatment of Medicare taxes, self-employed persons receive no offsetting deduction for any portion of the 0.9% surtax they must pay.

ADDITIONAL TAX ON INVESTMENT INCOME

- Also in addition to the regular income tax, the AMT and state-level income taxes, a new **3.8%** tax is now imposed on the "net investment income" of all individuals, trusts and estates.
- For individuals, the new 3.8% tax is imposed on "net investment income", but only to the extent such net investment income exceeds certain thresholds of adjusted gross income or "AGI" (as slightly modified to account for any foreign income tax credits claimed) – i.e., to the extent that such AGI exceeds thresholds of $250,000 for married couples filing jointly; $125,000 for a married person filing separately; and $200,000 for all other filers.
- The net investment income subject to the new 3.8% tax includes all the classic sources of investment income (e.g., interest, dividends, royalties, capital gains, annuities and rents). However, as a significant carved-out exception, these classic sources of investment income are not subject to the new 3.8% tax if derived from the individual's "active" conduct of a business.
- Income derived from rental real estate is generally presumed to be "passive" and therefore subject to the new 3.8% tax -- unless the individual taxpayer can establish that he or she is a "real estate professional".
- To determine how much "net" investment income is subject to the new 3.8% tax, all properly allocable expenses are permitted to offset such investment income (e.g., offset by investment interest expense, brokerage fees, rental property repair expenses, rental property management fees, etc.).
- Participants in pass-through entities (e.g., partners in partnerships, members in LLCs, stockholders in S corporations) are subject to the new 3.8% tax on their share of the entities net investment income to the extent that the participant is not engaged in the "active" conduct of the business of the entity.
- Trusts and estates are also subject to the new 3.8% tax on their net investment income to the extent not distributed out to beneficiaries -- especially significant since the assets of many trusts and estates are often concentrated heavily in investment activities. The new 3.8% tax is imposed on such undistributed net investment income of trusts and estates to the extent that AGI exceeds a modest current threshold of only $11,950.