New Medicare Tax Targets Investment Income

Written by Thomas Barker

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Last night, March 25, 2010, Congress passed a "reconciliation bill" that amends the Health Care Act signed by President Obama on March 23. The President is expected to sign the amended legislation next week.

The amended legislation introduces a new 3.8 percent Medicare "contribution" payable by individuals, and some estates and trusts, on "net investment income." The new tax will first apply in 2013. The new tax is imposed on net investment income, but only to the extent an individual's adjusted gross income exceeds a certain threshold amount. For married individuals who file joint returns, the threshold amount is $250,000. For a single individual, the threshold amount is $200,000.

"Net investment income" subject to the new tax includes interest, dividends, annuities, royalties, rents, and capital gains, minus deductions properly allocable to such income. Tax-exempt interest income, and distributions from tax-qualified retirement plans, including IRAs and Roth IRAs, are not included in net investment income. Income and gains derived from a "passive activity," however, are considered to be investment income. Also included are income and gains from an investment fund, even if the fund is classified as a "trader" for tax purposes. Perhaps ironically, while the legislation is not explicit on the point, it appears that social security benefits, to the extent they are subject to regular income tax, may also be included in net investment income subject to the new Medicare tax.

The following examples show how the new Medicare tax applies:

	Earned Income	Net Investment Income	Adjusted Gross Income over Threshold	Net Investment Income Subject to New Tax
Couple A	$50,000	$250,000	$50,000	$50,000
Couple B	$300,000	$50,000	$100,000	$50,000

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