PUBLICATION

High Income Taxpayers To Pay Additional 3.8 Percent Medicare Tax on Investment Income

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Section 1411 of the Internal Revenue Code (Code) was created pursuant to the Health Care and Education Reconciliation Act of 2010 and is effective as of January 1, 2013. Section 1411 imposes an additional 3.8 percent Medicare tax on investment income for certain high income taxpayers The Medicare tax will apply to taxpayers who are deemed passive pursuant to the passive activity rules under Section 469 of the Code and who exceed a threshold income amount. For example, the Medicare tax will apply to family members who receive distributions from an S corporation but do not materially participate in the business, if those family members have a high enough income. The purpose of this Alert is to generally discuss the circumstances that will trigger the 3.8 percent Medicare tax and an overview of certain increased tax rates anticipated in 2013.

Mechanics of the Additional Tax

Individuals: Applies to the lesser of net investment income or the excess of adjusted gross income over a threshold amount.

Trusts and Estates: Applies to the lesser of undistributed net investment income or the excess of adjusted gross income over the highest tax bracket amount.

Taxing Triggers

Adjusted Gross Income Threshold: The first trigger is whether a taxpayer's adjusted gross income (AGI) meets the threshold in Section 1411. In order to trigger the Medicare tax, a single taxpayer must have AGI in excess of $200,000, a married filing jointly return must have AGI in excess of $250,000 and a married filing separately return must have AGI of $125,000. The tax applies to the lesser of net investment income or the excess of adjusted gross income over the threshold amount referenced above.

Net Investment Income: The second trigger is that the investment income must be passive. Net investment income captures capital gains; income from partnerships, limited liability companies (LLC) and S corporations where a taxpayer does not materially participate; and income received through dividends, royalties, interest and rental payments. Taxpayers should review the passive activity rules in Section 469 to determine whether they are deemed "active" or "passive" for tax purposes in the partnership, LLC, S corporation and real estate purposes.

Exemptions: Several notable exemptions to the passive income rule referenced above include the sale of a principal residence, interest received on tax exempt bonds, and tax deferred plans and accounts.

- Principal Residence: The sale of a principal residence under Section 121 of the Code enables married taxpayers to exclude up to $500,000 and single taxpayers to exclude up to $250,000 of gain on the sale of such residence so long as the requirements of Section 121 are satisfied. To the extent that a gain on the sale of a principal residence is exempt under Section 121, the Medicare tax will not apply to that portion of the exempt gain. If additional gain exists, then Section 1411 would apply.

- Tax Exempt Bonds: Interest received from tax exempt bonds under Section 103 is not subject to this additional Medicare tax. Note however that Section 1411(c)(2) specifically provides that the Medicare tax will be applied to trading financial instruments or commodities.
- Tax Deferred Accounts: Tax deferred accounts such as IRAs, 401(k)s and 403(b) plans will generally not be included as net investment income for purposes of Section 1411. Additionally, the tax free build-up in certain life insurance plans will not be subject to Section 1411.

Trusts and Estates: Section 1411 will apply to trusts and estates to the extent the undistributed portion of passive income received exceeds the dollar amount at which the highest trust and estate bracket begins, which is only $11,650 for 2012. The additional Medicare tax should not apply to grantor trusts that are treated as owned by the grantor or another person under Sections 671 through 679 of the Code. To avoid the additional Medicare tax on non-grantor trusts and estates, a primary strategy will be to distribute income to the beneficiary(ies) to the extent the trust's or estate's income exceeds the amount at which the highest trust and estate bracket begins.

Examples of the Additional Medicare Tax

- Assume married taxpayers with combined salaries of $300,000 and $25,000 in capital gains from the sale of equities and $25,000 in interest and dividends. Because the taxpayers' income exceeds the $250,000 AGI threshold, these taxpayers will be subject to the additional 3.8 percent Medicare tax on their net investment income. The additional Medicare tax portion will be $1,900 ($50,000 times 3.8 percent).
- Assume a single taxpayer with a salary of $125,000 and $65,000 in capital gains. Because the taxpayer has AGI of only $190,000, the taxpayer does not meet the $200,000 AGI threshold and no portion of the net investment income will be subject to the Medicare tax.
- Assume a married taxpayer filing separately with a salary of $100,000 and $50,000 in capital gains. Because the taxpayer has AGI in excess of $125,000, the taxpayer will be subject to the additional Medicare tax in the amount of $25,000, or $950 ($25,000 times 3.8 percent), the amount of AGI ($150,000) in excess of the threshold amount ($125,000).

Tax Rate Increase in 2013

Capital Assets: Pursuant to the "Bush Era" tax cuts, taxpayers have enjoyed a 15 percent capital gains tax rate (28 percent on collectibles) on most assets since 2003. Capital gains are expected to be taxed at 20 percent in 2013 together with the additional Medicare tax of 3.8 percent discussed above. Assuming the Bush Era tax cuts are permitted to expire, higher income taxpayers will pay 23.8 percent in total capital gains.

Dividends: Qualified dividends, which are now provided preferential tax treatment at 15 percent, will return to ordinary income rates and may be taxed as high as 39.6 percent at the highest bracket. When the additional 3.8 percent Medicare tax is included, dividends are expected to be taxed as high as 43.4 percent.

Summary

The additional Medicare tax will be an unwelcomed addition to the overall tax burdens of many starting New Year's Day. Further, assuming the Bush Era tax cuts are permitted to expire, the overall tax rates will increase significantly on January 1. Taxpayers should consider certain tax planning strategies in order to mitigate the tax bite associated with these increases. If you would like to discuss the contents of this Tax Alert, please contact any attorney in the Firm's Tax Department.