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The Medicare Surtax & the Additional Medicare Tax: What is it? Will you pay it? Ways to reduce your tax liability

By Charles Sherry, M. Sc.

Here is what you need to know to navigate the 3.8% surtax on unearned investment income and the 0.9% additional tax on wages.

The Affordable Care Act (ACA) was designed to make health insurance more affordable, expand coverage, expand Medicaid, and help lower the overall cost of health care. The law was enacted in 2010.

One major source of revenue imposed by the ACA is centered around two new Medicare taxes that may affect high income earners:

- **The Net Investment Income Tax.** A 3.8% surtax on unearned investment income
- **The Additional Medicare Tax.** An additional 0.9% Medicare tax levied on wages

NET INVESTMENT INCOME TAX

First, let's review the surtax on unearned income that took effect on January 1, 2013.

The Net Investment Income Tax (NIIT) is imposed by section 1411 of the Internal Revenue Code. The NIIT applies at a rate of 3.8% to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts.

The tax is applied against the lesser of the taxpayer's net investment income or modified adjusted gross income (MAGI) in excess of the threshold amounts.

The income levels are shown in the following table. Keep in mind that the 3.8% surtax is in addition to ordinary income taxes and any alternative minimum tax.

| NIIT Surtax Thresholds | |
|---|-----------|
| Filing status | Threshold |
| Single, head of household | \$200,000 |
| Married filing jointly, qualifying widow(er) with a child | \$250,000 |
| Married filing separately | \$125,000 |

Source: IRS: Find out if Net Investment Income Tax applies to you

These thresholds are not indexed to inflation.

INCOME SUBJECT TO SURTAX

The tax introduced another layer of complexity into the tax code, but how it is applied will become clearer in the examples offered below. For now, let's look at which types of income are subject to the tax, and which are not.

- Unearned income will be subject to the tax. In general, income includes, but is not limited to:
 - Interest
 - Dividends
 - Rent
 - Nonqualified annuities
 - Royalties
 - Net capital gains
 - A passive activity—i.e., income from businesses in which the taxpayer does not actively participate
 - A trade or business of trading in financial instruments or commodities

- In addition, the net gain from property held for investment, including the taxable portion of a gain from selling a personal residence that is above the \$500,000/\$250,000 exclusion, is subject to the NIIT. Any profit below the exclusion is exempt from the surtax.
- Most trusts and estates will also be subject to the NIIT on investment income, with the threshold based on the level of taxable income that puts the entity into the highest tax bracket.

Indexing to inflation puts the threshold in 2024 at \$15,200. Above that level, the entity is subject to the 3.8% tax on investment income that isn't paid out to beneficiaries or heirs. Trusts not subject to the 3.8% surtax include:

- Trusts that are exempt from income taxes imposed by Subtitle A of the Internal Revenue Code, such as charitable trusts and qualified retirement plan trusts exempt from tax under IRC section 501, and Charitable Remainder Trusts exempt from tax under IRC section 664.
- A trust or decedent's estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B).
- Trusts that are classified as "grantor trusts" under IRC sections 671-679.
- Trusts that are not classified as "trusts" for federal income tax purposes such as Real Estate Investment Trusts and Common Trust Funds.
- Electing Alaska Native Settlement Trusts.
- Perpetual Care (Cemetery) Trusts.

INCOME NOT SUBJECT TO THE SURTAX

There are exclusions from the NITT. These include:

- Tax-exempt interest
- Any of the above sources of unearned income (taxable interest, dividends, capital gains, rents, etc.) as long as the taxpayer is actively engaged in the trade or business.
- Income from a business or activity the taxpayer is actively engaged in.

- Distributions from an IRA, a Roth IRA, qualified plans, 409A deferred compensation plans, and employer plans. But be careful. Distributions from a traditional IRA or a qualified plan are counted as MAGI, which could expose some or all investment income to the 3.8% surtax.
- A gain on the sale of a principal residence that is excluded from income (up to \$250,000 for single taxpayers; \$500,000 for a married couple).
- Gain on the sale of “qualified small business stock” that is excluded from income.
- Cash value that increases in life insurance
- Social Security benefits
- Wages
- Unemployment compensation
- Alimony
- Alaska Permanent Fund Dividends

Note: The NIIT does not apply to income from the sale of an interest in an S corporation, limited liability company or partnership, if the shareholder materially participates in the business.

SURTAX EXAMPLES

- Tom is single, earns \$120,000, and has dividends and capital gains of \$40,000. His MAGI of \$160,000 is below the threshold of \$200,000. Tom avoids the 3.8% surtax.
- Noah and Tina, married filing jointly, have wages of \$240,000 and net investment income of \$40,000 (MAGI of \$280,000). The 3.8% surtax applies to \$30,000.

Remember, the additional tax on investment income applies to the lesser of:

- The \$40,000 in investment income or
- The \$30,000 excess over the threshold of \$250,000 for joint returns
 - Sharon is single, has net investment income of \$250,000, and no other income. The 3.8% surtax would apply to \$50,000 of her income.

The additional tax on investment income applies to the lesser of:

- The \$250,000 in investment income or

- The \$50,000 excess over the threshold of \$200,000 for single returns
 - David and Wilma, married filing jointly, have combined salaries of \$500,000 and \$75,000 in investment income (MAGI of \$575,000). The 3.8% surtax applies to the \$75,000.

The additional tax on investment income applies to the lesser of:

- The \$75,000 in investment income or
- The \$325,000 excess over the threshold
 - Mark and Linda, married filing jointly, have combined salaries of \$325,000 and sell their home for a profit of \$550,000. The first \$500,000 of the gain is excluded, but the final \$50,000 isn't. This puts MAGI at \$375,000. The 3.8% surtax applies to \$50,000.

The additional tax on investment income applies to the lesser of:

- The \$50,000 in investment income (gain on the sale in excess of the \$500,000 exclusion) or
- The \$125,000 excess over the threshold
 - Cindy, single, has a salary of \$185,000 and net investment income of \$15,000, giving her a MAGI of \$200,000. The surtax does not apply.

However, if Cindy takes a distribution of \$30,000 from her traditional IRA, her new MAGI is \$230,000. She does not pay the 3.8% surtax on the IRA distribution, but the IRA distribution pushes her above the threshold. She pays the surtax on \$15,000.

The additional tax on investment income would apply to the lesser of:

- The \$15,000 in investment income or
- The \$30,000 excess over the threshold

MEDICARE TAX AND THE ADDITIONAL MEDICARE TAX

As a part of the FICA payroll tax, which includes the tax on wages for Social Security, an employer will withhold 1.45% of an employee's income in a calendar year. The employer also matches the contribution at a rate of 1.45%, or a total of 2.90% of earnings.

Employers are required to withhold an additional 0.9% in taxes on income above \$200,000, which helps

fund the ACA. There is no employer match for the Additional Medicare Tax. Like the NIIT, the Additional Medicare Tax went into effect in 2013. Like the NIIT, the Additional Medicare Tax thresholds are not indexed to inflation.

The 0.9% Additional Medicare Tax applies to Medicare wages, self-employment income, and railroad retirement (RTA) compensation that exceeds the following threshold amounts based on filing status:

- \$250,000 for married filing jointly;
- \$125,000 for married filing separately; and
- \$200,000 for all other taxpayers.

Tips are subject to the Additional Medicare Tax.

An employer must withhold the Additional Medicare Tax from wages and Railroad Retirement Tax Act (RTA) compensation it pays to an individual in excess of \$200,000 in a calendar year without regard to the individual's filing status or compensation paid by another employer.

ADDITIONAL MEDICARE TAX EXAMPLES

Jim earns \$210,000 and his wife, Jeanie, consults part-time, is self-employed, and earns \$35,000. Jim's employer must withhold the additional 0.9% tax on \$10,000, even though, as a couple, they are below the \$250,000 threshold. When Jim and Jeanie file, they will claim a credit for any withholding of the Additional Medicare Tax against the total tax liability shown on the individual income tax return (Form 1040).

Conversely, if Tom has wages of \$100,000 and his wife Sally earns \$200,000, neither employer will withhold the additional 0.9% Medicare tax. When they file, the couple must pay the tax on the \$50,000 above the threshold of \$250,000 for married filing jointly. They should either make estimated tax payments and/or request additional income tax withholding using Form W-4, Employee's Withholding Certificate.

Also be aware of this item: the value of taxable wages not paid in cash, such as noncash fringe benefits, will be subject to the 0.9% tax, if, in combination with other wages, they exceed the individual's applicable threshold.

In general, self-employed individuals are allowed an income tax deduction on one half of self-employment

taxes paid. However, the law does not allow a deduction for any portion of the additional 0.9% tax.

MINIMIZING THE BITE FROM THE 3.8% SURTAX

The NIIT is subject to the estimated tax provisions. Individuals, estates, and trusts that expect to be subject to the tax should adjust their income tax withholding or estimated payments in order to avoid underpayment penalties.

That said, as you evaluate the various approaches below, keep in mind that tax consequences alone should not be the driving force behind any of these strategies. Time horizon, riskiness of a security, suitability, how a security may fit into your overall strategy, and more should be considered.

- 1) **Bulk up on tax-exempt interest.** Consider tax-exempt municipals in lieu of other income-producing securities.
- 2) **Minimize exposure to dividend-paying stocks.** The American Tax Relief Act of 2012 (ATRA) and the health care bill raised the tax on dividends for high-income taxpayers from 15% to 23.8%. It may make sense to have your financial professional look to other income-producing securities or assets that have a greater potential for capital appreciation, as the NIIT will not be paid unless a gain is recognized.
- 3) **Increase contributions to tax-deferred retirement plans.** Maximize the contributions to IRAs, 401(k)s, or 403(b)s. Consider setting up a SEP-IRA or an individual 401(k) for self-employed clients. These plans have more beneficial contribution limits.
- 4) **Defer taxes.** Whenever possible, place investments that generate unearned income into tax-deferred accounts.
- 5) **Factor in retirement withdrawals.** Qualified withdrawals from a Roth IRA or Roth 401(k) are not included in MAGI and would not risk exposing investment income to the surtax. Consider converting a traditional IRA into a Roth. Or, if your employer allows it, convert your traditional 401(k) into a Roth 401(k). But be aware that a Roth

conversion is a taxable event, will add to MAGI, and may increase your exposure to the surtax.

- 6) **Time the income.** Can you spread income payments over several years, minimizing or eliminating the impact of the tax? Multiyear payments should be balanced. The financial stability of your employer must also be taken into consideration.
- 7) **Can passive income be converted to salary from an actively managed entity?** Some of the income might be subjected to the 0.9% tax, but it may reduce the 3.8% surtax.
- 8) **Consider installment sales.** Installment sales could defer income over several years and keep the seller under the MAGI limit or minimize the surtax.
- 9) **Use college savings accounts.** Save for education using Section 529 plans. Dividends and income generated under the umbrella of a college saving plans would not be subject to the NIIT.
- 10) **Make greater use of charitable trusts.** Consider charitable remainder trusts to defer recognition of income, and non-grantor charitable lead trusts that shift income away from the grantor to the trust.

- 11) **Plan for trust distributions.** Given the low threshold for trusts and estates, one planning consideration might be to distribute investment income to the beneficiaries if their higher thresholds would result in less tax. It goes without saying that such distributions must be consistent with the terms of the trust and the trustee's fiduciary duties.

THE BOTTOM LINE

This maze of complexity will create an extra level of frustration for many high-income investors. It's unlikely the levies can be completely avoided, but with prudent planning, you can face the next tax season armed with knowledge that eliminates unwanted surprises.

For additional information and before making any final decisions, please consult a tax advisor in addition to your regular financial professional.

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