

2013 Medicare Surtax: Taxing the Rich and the Haves

Effective on tax year after December 31, 2012, a Medicare Tax increase of 0.90% is set to become effective along with a new 3.8% Medicare Surtax to be levied on unearned or investment income for high income taxpayers. These new taxes were part of an attempt to offset the increased costs associated with healthcare reform. According to the Congressional Budget Office¹, the new tax is expected to add \$318 billion to the federal revenue over the next 10 years.

Current Law

Social Security benefits and certain Medicare benefits are financed by payroll taxes on earned wages. Federal Insurance Contributions Act² (FICA) imposes equal tax on employers and employees based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the OASDI (Old-Age, Survivors, and Disability Insurance) tax equal to 6.2% of covered wages up to the taxable wage base (\$113,700 for 2013) and (2) the Medicare hospital insurance ("Medicare") tax amount equal to 1.45% on

all earned wages without limit. The combined OASDI is 12.4% and combined Medicare is 2.9% on earned wages.

New Law

1. "Taxing the Rich" - Medicare Tax Increases on Earned Wages³

A taxpayer is subject to additional Medicare Tax if the taxpayer's wages, other compensation, or self-employment income (together with that of the taxpayer's spouse if filing jointly) exceeds the threshold amount in the table below for the taxpayer's filing status:

Filing Status	Threshold Amount
Single	\$200,000
Married filing jointly	\$250,000
Married filing separately	\$125,000
Head of household (with qualifying person)	\$200,000
Qualifying widow(er) with dependent child	\$200,000

There is no employer matching contribution for this additional Medicare tax. An employer is expected to withhold the additional Medicare Tax on wages to an employee in excess of \$200,000 in a calendar year even though an employee may not be liable for the additional Medicare Tax.

¹ <http://www.cbo.gov/sites/default/files/cbofiles/attachments/43471-hr6079.pdf>

² http://www.ssa.gov/policy/docs/quickfacts/prog_highlights/RatesLimits2013.pdf

³ <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax>

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For example, the combined wages for the employee and his/her spouse (when filing a joint return) fall short of the \$250,000 liability threshold. Under this example, the excess Medicare Tax would be credited against the total tax liability shown on the individual's income tax return for that year.

2. "Taxing the Haves" - Unearned Income Medicare Contribution

Beginning on January 1, 2012, the Reconciliation bill § 1402⁴ and the new IRC § 1411⁵, impose a 3.8% surtax on unearned income based on certain threshold amounts and under certain circumstances.

In the case of an individual taxpayer, a 3.8% surtax is imposed on the lesser of:

- (A) net investment income ("NII") for such taxable year, or
- (B) the excess of the modified adjusted gross income ("MAGI") for such taxable year, over the "**Threshold Amount**".

In the case of an estate or trust, a 3.8% surtax is imposed on the lesser of:

- (A) the undistributed net investment income for such taxable year, or

- (B) the excess of the adjusted gross income (as defined in § 67(e)⁶) for such taxable year over the dollar amount at which the highest tax bracket in § 1(e)⁷ begins for such taxable year.

Net Investment Income

NII is made up of three types:

Type I: Gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in next income type II

Type II: Gross income derived from a passive activity (within the meaning of § 469⁸), or a trade or business of trading in financial instruments or commodities, as defined in § 475(e)(2)⁹

Type III: Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in income type II

⁴ <http://www.gpo.gov/fdsys/pkg/PLAW-111publ152/pdf/PLAW-111publ152.pdf>

⁵ <http://www.law.cornell.edu/uscode/text/26/1411>

⁶ Section 67(e)

<http://www.law.cornell.edu/uscode/text/26/67>

⁷ Section 1(e)

<http://www.law.cornell.edu/uscode/text/26/1>

⁸ Section 469

<http://www.law.cornell.edu/uscode/text/26/469>

⁹ Section 457(e)(2)

<http://www.law.cornell.edu/uscode/text/26/475>

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Certain "income" is specifically excluded from being considered NII:

- A disposition of an interest in a partnership or S corporation
- Any distribution from a plan or arrangement described in § 401(a), 403(a), 403(b), 408, 408A, or 457(b) (i.e. qualified retirement plans, IRAs, stock bonus plans, qualified annuity plans, and deferred compensation plans for state and local governments and tax-exempt organizations)

- Compare the Excess Amount to the taxpayer's NII and determine which the Lower Amount is. The new 3.8% Medicare surtax applies to the Lower Amount.

High income taxpayers, property owners, and closely held business owners should consult with their tax advisors prior to the end of 2012 to assess their income and tax situation and to take prudent steps to respond to the application of the new Medicare surtax.

Modified Adjusted Gross Income

MAGI means adjusted gross income increased by the excess of:

- (1) the amount excluded from gross income (i.e. foreign earned income under § 911(a)(1)), over
- (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).

To estimate a taxpayer's liability for the Unearned Income Medicare surtax:

- Determine if the MAGI is above the applicable Threshold amount. If so, identify the Excess Amount.
- Determine the taxpayer's NII.

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