Planning Early to Lessen the 3.8% Medicare Tax on Investment Income

Starting in 2013, the recently enacted health care reform law expands the Medicare tax base for top earners in two ways. First, by imposing an additional Hospital Insurance (HI) tax rate of 0.9 percent on earned income in excess of $200,000 for individuals and $250,000 for married couples filing jointly; and second by creating a new 3.8 percent tax on investment income applicable to certain higher-income taxpayers.

This Current Comment focuses on how to minimize the future potential impact of the new 3.8 percent tax on investment income.

The 3.8% unearned income Medicare contributions tax is imposed on the lesser of:

(i) Net investment income or

(ii) The excess of modified adjusted gross income (MAGI) over the threshold amount ($200,000 for single individuals or heads of households; $250,000 for married couples filing a joint return and surviving spouses; and $125,000 for married couples filing separate returns). [Code Sec. 1411(a)(1); Code Sec. 1411(a)(1)].

Net investment income includes interest, dividends, royalties and rents, disposition gains from a passive activity, and income earned from a trade or business classified as passive activity. Net investment income also includes the portion of an annuity payment that is not a return of the initial investment in the contract. In calculating net investment income, investment income is reduced by normal deductions.

Net investment income does not include distributions from qualified retirement plans and IRAs.

Only individuals with MAGI above the applicable threshold amount will be subject to the tax. For example, in 2013, a single taxpayer who has net investment income of $60,000 and MAGI of $190,000 will not be liable for the tax, because his MAGI ($190,000) doesn't exceed the threshold amount ($200,000).

On the other hand, a single taxpayer who has net investment income of $90,000 and MAGI of $230,000 would pay the tax on the $30,000. This is the amount by which his MAGI exceeds the threshold amount of $200,000 and is "the lesser amount" when compared to his net investment income of $90,000. The tax would be $1,140 ($30,000 × 3.8%). A single taxpayer with net investment income of $100,000 and MAGI of $300,000 would pay the 3.8% tax on the

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on the full amount of his net investment income ($100,000) since MAGI exceeds the threshold amount by $100,000.

For an estate or trust, the tax is 3.8% of the lesser of: (1) undistributed net investment income or (2) the excess of AGI (see: I.R.C. § 67(e) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins (see: I.R.C. § 1411(a)(2)). Charitable remainder and other tax-exempt trusts are excluded.

# Planning Early to Mitigate the Tax Bite

The 3.8% tax is in addition to any otherwise applicable tax that may be imposed on the investment income item. Because higher income taxes and capital gains taxes may be just around the corner, reducing the 3.8% tax takes on heightened importance.

Tax-exempt bond interest is not subject the 3.8% tax. Thus investing a greater portion of one's portfolio into tax-exempt bonds after 2012 will help to reduce exposure to the 3.8% tax.

Under I.R.C. §121, taxpayers who sell their primary residence may qualify to exclude up to $250,000 (or $500,000 in the case of a married couple filing jointly) of such gain. The gain from the sale of a principal residence that is excluded under I.R.C. § 121 is not subject the 3.8% tax. Note that if the gain exceeds the $250,000 / $500,000 limit on the exclusion, those amounts would be subject to the 3.8% tax. Gain from the sale of a secondary residence would be subject to the tax. Clients expecting to realize a substantial gain on a principal residence (in excess of the $250,000 / $500,000 limits) and are planning on selling in the near future should try to close the deal before 2013 (the year the new 3.8% tax kicks in). Completing a planned sale of a highly appreciated second home before 2013 could similarly save the 3.8% tax.

Investment income, for purposes of the 3.8% Medicare tax, doesn't include distributions from qualified employer plans and IRAs. [I.R.C. § 1411(c)(5)]. Even though distributions from qualifying retirement plans are not considered investment income for purposes of the 3.8% tax certain distributions could be included in MAGI and thus nudge the taxpayer over the MAGI income threshold causing other types of investment income to be subject to the tax. Qualified distributions from Roth IRAs are tax-free and thus won't be included in MAGI (or be subject to the Medicare tax).

Clients thinking of rolling over regular IRAs to Roth IRAs should do so before 2013 to avoid jacking up their MAGI as a result of the rollover. (For IRA-to-Roth-IRA conversions occurring in 2010 (unless a taxpayer elects otherwise) none of the gross

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income from the conversion is included in income in 2010; half of the income resulting from the conversion will be includible in gross income in 2011 and the balance in 2012.)

Income and gains derived from a "passive activity," however, are considered to be investment income. Thus, the 3.8% tax applies to a trade or business if it is a I.R.C. § 469 passive activity of the taxpayer, or a trade or business of trading in I.R.C. §475(e)(2) financial instruments or commodities. [Code Sec. 1411(c)(2)]. The tax doesn't apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation. But income, gain, or loss on working capital isn't treated as derived from a trade or business and thus is subject to the tax. [Code Sec. 1411(c)(3)].

Investment income does not include amounts subject to SECA (Self-Employment Contributions Act) taxes. [Code Sec. 1411(c)(6)].