Understanding the New Medicare Taxes

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Overview

- Affordable Care Act of 2010 required that:
  - All individuals will be required to obtain health care coverage or pay a penalty (unless exempt) (repealed under TCJA)
  - Employer coverage will satisfy the requirement (as long as minimum employer requirements are met)
  - "Lower"-income individuals may qualify for a premium assistance tax credit, or cost-sharing arrangements, or a voucher to help pay for health insurance
  - State insurance exchanges will be developed where individuals can shop for coverage
  - New taxes created to help manage costs of expanded programs

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Medicare Earned Income Tax Started in 2013

- Additional "Hospital Insurance tax" of 0.9% on earned income in excess of applicable thresholds
  - Increased from the "normal" 1.45% hospital insurance tax amount for high income taxpayers
    - Results in total tax of 2.35% for "excess" income
  - Threshold amounts are $200,000 for individuals; $250,000 for married filing jointly
    - Unlike regular hospital insurance tax, is applied to joint income for a married couple
    - Amounts are *not* indexed for inflation

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Medicare Earned Income Tax Started in 2013

- Tax is applied to the individual taxpayer side only; does not apply to the employer's share of hospital insurance tax
- Employer is responsible for withholding for excess wages for *individuals* above the threshold
  - Withholding does *not* apply for married couples over the $250,000 threshold
  - Consequently, married couples may need to adjust estimated tax payments to account for this!

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Medicare Earned Income Tax Started in 2013

- Applies to self-employed individuals as well
  - Increase from the "normal" 2.9% hospital insurance tax amount for high income self-employed individuals
    - Results in total tax of 3.8% for "excess" income
    - Excess 0.9% not eligible for the deduction for one-half of self employment taxes
  - Threshold for self-employment taxes is adjusted to the extent the Medicare tax also applied to wages
    - Example: Client earns $120,000 of wages; only needs an additional $80,000 of self-employment income to reach the threshold for Medicare taxes

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Medicare Unearned Income Tax Started in 2013

- Additional "unearned income Medicare contributions tax" of 3.8% (for individuals and trusts) on lesser of:
  - Net investment income
  - Excess of modified AGI over threshold amounts
- Applies *in addition* to any other income taxes that may apply
- Included when determining estimated tax payments
- Often called the "NIIT" (Net Investment Income Tax)

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Medicare Unearned Income Tax Started in 2013

- Investment Income includes:
  - Gross income from interest, dividends, annuities, royalties, and rents;
  - Other gross income derived from a passive activity (e.g., real estate investing) or a business of trading in financial instruments or commodities
  - Net gain attributable to the disposition of property (i.e., "capital gains")
- Net investment income is the sum of the above, reduced by deductible investment expenses
  - Limits that apply for regular tax purposes apply here, too!

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Medicare Unearned Income Tax Started in 2013

- Income that is excluded for the purposes of NIIT:
  - Income that is already excluded or exempt from tax
  - Any income or gains attributable to or derived in the ordinary course of a trade or business
    - Investment income from working capital may still apply in some situations
  - Any income to which (self-)employment taxes also apply
    - Net Unrealized Appreciation (NUA) is not subject to the NIIT!
  - Gains from the sale of a partnership or S corporation, except to the extent gain would have been recognized on the sale of business assets
  - Distributions from retirement accounts

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Medicare Unearned Income Tax Started in 2013

- Modified AGI
  - Taxpayer's Adjusted Gross Income
  - Increased by any foreign earned income that was excluded (in excess of associated deductions)
- Applicable threshold amount
  - $250,000 for married filing jointly (and surviving spouses)
  - $125,000 for married filing separately
  - $200,000 for all other taxpayers (i.e., single, head of household, etc.)
  - Threshold amounts are *not* indexed for inflation

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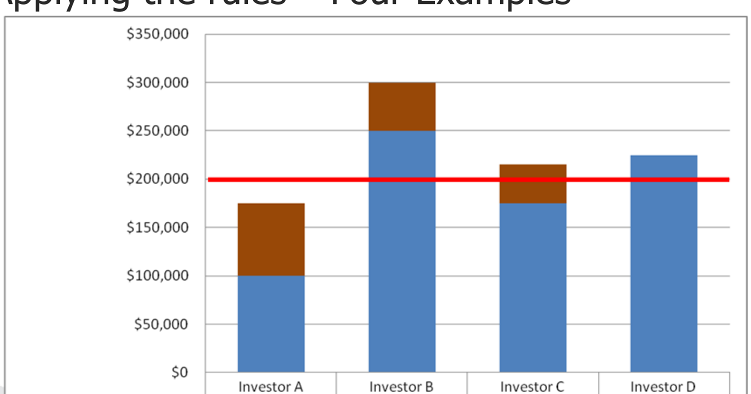
Medicare Unearned Income Tax Started in 2013

- Applying the rules – Four Examples



	Investor A	Investor B	Investor C	Investor D
Net Investment Income	$75,000	$50,000	$40,000	$0
Other Income	$100,000	$250,000	$175,000	$225,000

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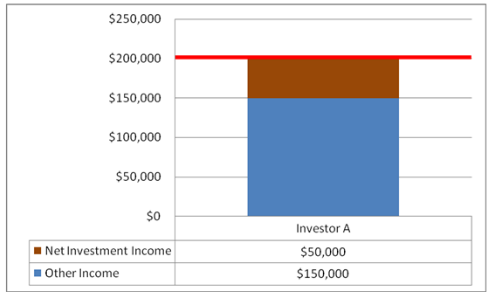
Medicare Unearned Income Tax Started in 2013

- Understanding the crossover zone
  - Additions to income force investment income over the applicable threshold
  - Can cause *non*-investment income to create Medicare taxes!
  - Doesn't apply when:
    - MAGI is still below threshold
    - Investment income is fully taxed above threshold



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Medicare Unearned Income Tax Started in 2013

- Planning Implications - mitigating the NIIT
  - Reduce Net Investment Income
    - Shift focus to investments that aren't taxable (i.e., re-evaluate tax-equivalent yields)
    - Be certain available deductions are maximized; and claimed against investment income, where appropriate!
    - Time income in years where net investment income falls below the threshold
      - Timing capital gains
      - Use of annuities or life insurance?
      - Be cautious to balance tax gains with economic impact!
    - Use of accounts exempt from tax
      - Tax-preferred accounts for retirement, education, etc.

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Medicare Unearned Income Tax Started in 2013

- Planning Implications - mitigating the NIIT
  - Reducing MAGI and Managing Crossover Zone
    - Timing income to avoid the crossover zone
      - May be acceleration or deferral of income
      - Capital gains and losses
      - Roth vs traditional contributions
      - Roth conversions
  - Increase income to compensate (if you can)?
    - Raising rents for high-income real estate investors?
      - Limited impact due to real estate depreciation and other deductions anyway?
      - Tax may still be due on sale of real estate property?

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Medicare Unearned Income Tax Started in 2013

- Evaluating client exposure
  - Is MAGI in excess of the applicable threshold?
  - Is there any net investment income
  - Determine the lesser of net investment income or excess of MAGI over the threshold amount
- Combines with other tax rate changes
  - Interest & S/T gains taxed at ordinary income + 3.8%
  - Long-term capital gains + 3.8%
  - Qualified dividends + 3.8%

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Medicare Unearned Income Tax Started in 2013

- Evaluating Client Exposure
  - Must have MAGI in excess of applicable thresholds – i.e., "relatively" affluent clients
  - Many clients will only have limited exposure in "big income" years
    - Significant bonus
    - Exercise of stock options
    - Large capital gains from investment sales
    - Sale of a business (albeit w/ exceptions mentioned earlier)
    - Planning involves income shifting to non-exposure years

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Medicare Unearned Income Tax Started in 2013

- Evaluating Client Exposure
  - Clients with ongoing exposure
    - Significant pension
    - Large amount of "passive" portfolio income (requires multi-million dollar portfolio?)
    - Ongoing IRA withdrawals, and/or large RMDs (also requires multi-million dollar IRA?)
    - Large amounts of passive income from businesses
    - Planning includes both reducing net investment income, and where possible to shift income amongst years to manage crossover zone

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Medicare Unearned Income Tax Started in 2013

- Evaluating Client Exposure
  - Clients with ongoing exposure (con't)
    - Significant ongoing employment income(!)
    - Planning via income shifting may be especially appealing (to retirement years with less exposure)
    - Planning to reduce net investment income in current years may help
    - If income is near threshold, short-term crossover zone planning may be feasible

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Medicare Unearned Income Tax Started in 2013

- Additional issues for trusts and estates
  - Trusts taxed on the lesser of:
    - *Undistributed* net investment income
    - Excess of trust or estate's AGI over the threshold amount
  - Applicable threshold amount is the dollar amount to start the top tax bracket (currently, $12,750!)
    - Automatically indexed for inflation with tax brackets
  - Applies to *undistributed* net income
    - Control taxation at the trust versus beneficiary levels
    - Balancing tax issues with other trust goals

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Medicare Unearned Income Tax Started in 2013

- A Word of Caution
  - NIIT rate *is* only 3.8%
  - Be cautious to balance tax savings against economic costs of other investment decisions
  - Income shifting can save Medicare tax but lose on ordinary income tax brackets (Federal or state!)
  - Don't let the tax tail wag the investment dog!

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Questions?

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