

Planning for the 3.8 Percent Medicare Tax on Investment Income

The health care reform package (the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010) imposes a new 3.8 Medicare contribution tax on the investment income of higher-income individuals. Although the tax does not take effect until 2013, it is not too soon to examine methods to lessen the impact of the tax.

Net investment income. Net investment income, for purposes of the new 3.8 percent Medicare tax, includes interest, dividends, annuities, royalties and rents and other gross income attributable to a passive activity. Gains from the sale of property that is not used in an active business and income from the investment of working capital are treated as investment income as well. However, the tax does not apply to nontaxable income, such as tax-exempt interest or veterans' benefits. Further, an individual's capital gains income will be subject to the tax. This includes gain from the sale of a principal residence, unless the gain is excluded from income under Code Sec. 121, and gains from the sale of a vacation home. However, contemplated sales made before 2013 would avoid the tax.

The tax applies to estates and trusts, on the lesser of undistributed net income or the excess of the trust/estate adjusted gross income (AGI) over the threshold amount (\$11,200) for the highest tax bracket for trusts and estates, and to investment income they distribute.

Deductions. Net investment income for purposes of the new 3.8 percent tax is gross income or net gain, reduced by deductions that are "properly allocable" to the income or gain. This is a key term that the Treasury Department expects to address in guidance, and which we will update you on developments. For passively-managed real property, allocable expenses will still include depreciation and operating expenses. Indirect expenses such as tax preparation fees may also qualify.

For capital gain property, this formula puts a premium on keeping tabs on amounts that increase your property's basis. It also puts the focus on investment expenses that may reduce net gains: interest on loans to purchase investments, investment counsel and advice, and fees to collect income. Other costs, such as brokers' fees, may increase basis or reduce the amount realized from an investment. As such, you may want to consider avoiding installment sales with net capital gains (and interest) running past 2012.

Thresholds and impact. The tax applies to the lesser of net investment income or modified AGI above \$200,000 for individuals and heads of household, \$250,000 for joint filers and surviving spouses, and \$125,000 for married filing separately. MAGI is AGI increased by foreign earned income otherwise excluded under Code Sec. 911; MAGI is the same as AGI for someone who does not work overseas.

Example. Jim, a single individual, has modified AGI of \$220,000 and net investment income of \$40,000. The tax applies to the lesser of (i) net investment income (\$40,000) or (ii) modified AGI (\$220,000) over the threshold amount for an individual (\$200,000), or \$20,000. The tax is 3.8 percent of \$20,000, or \$760. In this case, the tax is not applied to the entire \$40,000 of investment income.

The tax can have a substantial impact if you have income above the specified thresholds. Also, don't forget that, in addition to the tax on investment income, you may also face other tax increases proposed by the Obama administration that could take effect in 2013. The top two marginal income tax rates on individuals would rise from 33 and 35 percent to 36 and 39.6 percent, respectively. The maximum tax rate on long-term capital gains would increase from 15 percent to 20 percent. Moreover, dividends, which are currently capped at the 15 percent long-term capital gain rate, would be taxed as ordinary income. Thus, the cumulative rate on capital gains would increase to 23.8 percent in 2013, and the rate on dividends would jump to as much as 43.4 percent. Moreover, the thresholds are not indexed for inflation, so a greater number of taxpayers may be affected as time elapses. Congress may step in and change these rate increases, but the possibility of rates going up for upper income taxpayers is sufficiently real that tax planning must take them into account.

Exceptions. Certain items and taxpayers are not subject to the 3.8 percent tax. A significant exception applies to distributions from qualified plans, 401(k) plans, tax-sheltered annuities, individual retirement accounts (IRAs), and eligible 457 plans. At the present time, however, there is no exception for distributions from nonqualified deferred compensation plans subject to Code Sec. 409A, although some experts claim that not carving out such an exception was a Congressional oversight that should be rectified by an amendment to the law before 2013.

The exception for distributions from retirement plans suggests that potentially taxed investors may want to shift wages and investments to retirement plans such as 401(k) plans, 403(b) annuities, and IRAs, or to 409B Roth accounts. Increasing contributions will reduce income and may help you stay below the applicable thresholds. Small business owners may want to set up retirement plans, especially 401(k) plans, if they have not yet established a plan, and should consider increasing their contributions to existing plans.

Another exception covers income ordinarily derived from a trade or business that is not a passive activity under Code Sec. 469, such as a sole proprietorship. Investment income from an active trade or business is also excluded. However, SECA (Self-Employment Contributions Act) tax will still apply to proprietors and partners. Income from trading in financial instruments and commodities is also subject to the tax. The tax does not apply to income from the sale of an interest in a partnership or S corporation, to the extent that gain of the entity's property would be from an active trade or business. The tax also does not apply to business entities (such as corporations and limited liability companies), nonresident aliens (NRAs), charitable trusts that are tax-exempt, and charitable remainder trusts that are nontaxable under Code Sec. 664.

Please contact our office if you would like to discuss the tax consequences to your investments of the new 3.8 percent Medicare tax on investment income.

