11 Ways to Minimize the Bite from the New Medicare Taxes

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–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.

Though the Patient Protection and Affordable Care Act (PPACA) faces an uncertain future following the election of 2016, Obamacare remains the law of the land for the time being. The continued existence of the law has important implications for the uninsured, small businesses, and also high-income earners.

One major source of revenues imposed by PPACA, as amended by the Health Care and Education Reconciliation Act of 2010, is centered around two new Medicare taxes:

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

Net Investment Income Tax

First, let's review the new 3.8% surtax on unearned income that took effect on January 1, 2013.

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

These thresholds are shown in the following table. Keep in mind that the 3.8% surtax is in addition to ordinary income tax and any alternative minimum tax. Plus, the thresholds are not indexed to inflation.

Medical Surtax Thresholds

Filing status	Threshold
Single, head of household	$200,000
Married filing jointly, qualifying widow(er)	$250,000
Married filing separately	$125,000

Source: Patient Protection and Affordable Care Act

Income subject to surtax

The new tax will introduce another layer of complexity into the tax code, but how it will be 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. This includes gross income from:
  - Taxable interest
  - Dividends
  - Rent
  - Taxable 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 surtax. Any profit below the exclusion is exempt from the surtax.
- Most trusts and estates will also be subject to the tax 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 2017 at $12,300. 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 in which all of the unexpired interests are devoted to one or more of the purposes described in IRC 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.

Income not subject to the surtax

There will be exclusions to the new tax. 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 income

Note: The surtax does not apply to income from the sale of an interest in an S corporation or partnership, if the gain of the entity's property would be from an active trade or 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 and 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 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 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.

But 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

Additional Medicare Tax

Employers are now required to withhold an additional 0.9% in taxes on income above $200,000 in a calendar year to pay for Medicare. There is no employer match for the Additional Medicare Tax. For example, like the 3.8% surtax, the Additional Medicare Tax threshold snares individual filers and heads of household who earn over $200,000, married filing jointly in excess of $250,000, and married filing separately above $125,000 (including net self-employment income).

For instance, 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 makes $200,000, neither employer will withhold the additional 0.9% Medicare tax. When it comes time to file, the couple must pay the tax on the $50,000 above the threshold. Tom and/or Sally should either make estimated tax payments and/or request additional income tax withholding using Form W-4, Employee's Withholding Allowance 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 the 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 surtax 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 of any these strategies. Time horizon, riskiness of a security, suitability, and how a security may fit into your overall strategy 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 have raised the tax on dividends for high-income taxpayers from 15% to 23.8%. It may make sense to have your advisor look to other income-producing securities or assets that have a greater potential for capital appreciation, as the surtax 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. As already mentioned, 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 taking advantage of the new provision in ATRA that allows for the conversion of a traditional 401(k) into a Roth 401(k). But be aware that a Roth conversion is a taxable event, will add to MAGI, and will possibly increase your exposure to the surtax.

6. Time the income. Can you spread out 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 and Coverdell Education Savings Accounts.
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 almost goes without saying that such distributions must be consistent with the terms of the trust and the trustee's fiduciary duties.

The bottom line

The new 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 advisor.

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