New 3.8% Medicare Contribution Tax on Unearned Income

Beginning in 2013, the 2010 Health Care Act, as amended by the 2010 Health Care Reconciliation Act, imposes a Medicare contribution tax on unearned income (Medicare contribution tax) on individuals, estates, and trusts. The tax is generally levied on income from interest, dividends, annuities, royalties, rents, and capital gains, but can also be levied on home sale gains in excess of the applicable exclusion amount.

For individuals, the tax is 3.8% of the lesser of (a) *net investment income* or (b) the excess of *modified adjusted gross income* (MAGI) over the applicable threshold amount. Net investment income is investment income reduced by the deductions properly allocable to such income. Fortunately, qualified retirement plan distributions are not included in investment income. MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to the foreign earned income. The threshold amount for those subject to the tax is $250,000 for joint returns or surviving spouses, $125,000 for separate returns, and $200,000 in other cases.

Where possible, taxpayers can reduce their 2013 MAGI by receiving 2012 bonus, profit sharing, or other incentive payments in 2012 versus 2013. But recognize that doing so will accelerate into 2012 the regular income tax due on these payments. If 2013 MAGI is under the applicable threshold amount, there will be no Medicare contribution tax liability.

Example: Single taxpayer's MAGI exceeds the $200,000 threshold.

Carol, a single taxpayer, has net investment income of $100,000 and MAGI of $220,000 in 2013. She would pay a Medicare contribution tax on $20,000, the amount by which her MAGI exceeds the $200,000 threshold since this is less than her net investment income of $100,000. Carol's 2013 Medicare contribution tax would be $760 ($20,000 × 3.8%).

However, if a taxpayer's 2013 MAGI exceeds the threshold amount by at least the amount of the net investment income, the taxpayer will pay 3.8% on the full amount of his or her net investment income.

Example: Taxpayer's MAGI exceeds the threshold by more than net investment income.

Wesley, a single taxpayer, has 2013 net investment income of $110,000 and MAGI of $400,000. Because his MAGI exceeds the $200,000 threshold amount by more than his net investment income, he would pay a Medicare contribution tax on his full $110,000 net investment income. Wesley's 2013 Medicare contribution tax would be $4,180 ($110,000 × 3.8%).

A large home sale gain *could* be subjected to the Medicare contribution tax. However, any amount realized from the sale of a principal residence excluded from federal taxation (up to $250,000; $500,000 for certain married couples filing a joint return) is not subject to the Medicare contribution tax.

Example: Home sale gain in excess of the $500,000 exclusion.

The Clarks, a married couple, have 2013 AGI of $260,000. They sell their principal residence for $1.2 million, and realize a net gain of $700,000. Their 2013 MAGI is $460,000 ($260,000 AGI + $200,000 home sale gain in excess of $500,000). Because their MAGI exceeds the $250,000 threshold for joint filers, they would pay a Medicare contribution tax on $200,000 from the sale of their home. [The Medicare contribution tax is computed on the lesser of the $200,000 applicable home sale gain or $210,000 ($460,000 MAGI – the $250,000 threshold).] Their 2013 Medicare contribution tax would be $7,600 ($200,000 × 3.8%).

Planning Tip: If a taxpayer anticipates receiving large capital gains from the sale of a business, investments, a principal residence, real estate, etc., these transactions should be completed before 2013, if possible, to avoid the Medicare contribution tax in 2013.

Finally, the Medicare contribution tax is paid in addition to the 0.9% Medicare surtax on wages and self-employment income in excess of the applicable threshold amounts (see above). Taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes in 2013.