Reinhart

Part Two of Health Care Reform Legislation: Focus on Increased Medicare Taxes

On April 1, 2010, we sent the e-alert, "Four New Tax Acts Affect Health Care, Hiring and Small Business," highlighting an overview of tax law changes. As a follow-up, this alert provides more detail on the "Medicare tax" and identifies planning opportunities to minimize the impact of the increased tax that takes effect by 2013.

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What Are the Changes to the Medicare Tax Increase?

The "Medicare" tax change has two components. First, there is a general increase in the employee portion of Hospital Insurance tax (also referred to as the "Medicare" portion of FICA) for higher income employees and self-employed individuals. Second, there is a new "Medicare" tax on certain investment income of higher income taxpayers.

Reinhart Comment: The new "Medicare" tax on investment income is not part of the current Medicare system. In reality, it amounts to a new tax on investment income that is intended to help pay for health care reform.

In 2013, the "employee portion" of the Hospital Insurance tax increases by 0.9%. This additional 0.9% applies to wages received from employment (and self-employment income) over $200,000 ($250,000 for families).

> **Illustration**: An individual earning $300,000 will now pay an additional $900 of Hospital Insurance tax (0.9% times earned income of $100,000 over the threshold).

Beginning in 2013, a 3.8% "Medicare" tax applies to "net investment income" of taxpayers with adjusted gross income over $200,000 ($250,000 for families). The tax only applies to net investment income to the extent such income and the taxpayer's other income exceed the modified AGI threshold.

Reinhart Comment: The 3.8% tax effectively mirrors the 2.9% paid by employees and employers combined on FICA earnings plus the 0.9% Hospital Insurance tax increase.

Illustration: An individual with "net investment income" of $50,000, earned income of $300,000 and a modified AGI of $350,000 would pay the 3.8% Medicare tax on the $50,000 of net investment income. The excess of modified AGI over the threshold is $150,000 for this taxpayer, so net investment income is lower and would be used to calculate the tax. The individual would pay an extra $1,900 in "Medicare" tax (3.8% times $50,000) and would also have to pay the 0.9% Hospital Insurance tax on the $100,000 that is earned income above the $200,000 threshold.

Illustration: An individual with "net investment income" of $50,000 and a modified AGI of $225,000 would pay an additional 3.8% tax of $25,000. There is a $25,000 excess over the AGI threshold, so only the excess is taxed.

Illustration: An individual with "net investment income" of $300,000 and modified AGI of $100,000 (due to active business losses), would pay no additional 3.8% tax. There is no excess modified AGI over the threshold, so it is the lower amount. The employee would not pay the additional 0.9% either because it appears he has no earned income over the threshold.

Which Taxpayers Will the Taxes Affect?

The 0.9% Hospital Insurance tax applies to wages received from employment and self-employment income. Like other payroll taxes, employers must withhold this tax, and can be liable for the tax if they fail to withhold it. Employees may also have personal liability. In determining the amount to withhold, employers need not consider the employee's spouse's wages or other jobs held by the employee. If the spouse's earnings or earnings from another job change whether the family meets the threshold, the employer may withhold too much or too little. For self-employed taxpayers, adjustments are made to coordinate with FICA and special deductibility rules apply.

The 3.8% "Medicare" tax applies to individuals, trusts, and estates (with different application rules for trusts and estates and with some exceptions aimed largely at charitable and tax-exempt trusts). "Net investment income" encompasses income from a large variety of sources. An individual's "net investment income" includes: gross income from dividends, royalties, interest, annuities, rents (unless derived from a trade or business that the tax does not apply to), gross income earned from a passive trade or business, gross income from trading financial commodities, and "net gain" from disposing of property (except for property held by an active trade or business) that is used in computing taxable income. The taxpayer can then subtract deductions properly allocable to the income or gain. Net investment income does not include income that is (i) not taxable/gross income, (ii) subject to self-employment 0.9% tax or (iii) earned in a business in which the taxpayer actively participates. The tax does not apply to qualified retirement plan distributions.

Income from disposition of a partnership interest or stock in an S corporation is calculated based on the amount of net gain/loss to the taxpayer if all the properties were sold for fair market value. It is unclear how this will apply if the taxpayer desires to sell less than his full interest. This method measures the net gain or loss from the entity on property that is not related to the active trade or business.

> **Illustration**: An individual desires to sell his 50% interest in an S corporation in which there is no basis. To calculate the net gain, the IRS considers the gain to him if the S corporation had sold all its properties at fair market value. Assume the overall net gain on properties not attributable to the active trade or business would be $1,000,000. The individual would have $500,000 of net gain.

Even if a taxpayer's earnings and modified AGI or net investment income are low enough now that the taxpayer avoids the tax, the tax may apply in the future due to inflation, as the threshold amounts are not indexed for inflation.

How Can Taxpayers Minimize the Impact of the Taxes?

Taxpayers might consider ways of decreasing taxable income and "net investment income" to decrease these taxes. The efficacy of each suggestion is dependent on the taxpayer's personal circumstances and are subject to changes in the tax law.

- Invest in instruments that do not result in taxable income, such as municipal bonds
- Convert passive activities into active ones (*e.g.*, participate more than 500 hours per year or spend at least 100 hours and as much as anyone else)
  Illustration: An individual participates in an S corporation that he owns. He

works 450 hours per year. Two other owners also participate 450 hours per year. A fourth participant works 600 hours per year. The individual may want to increase his participation by 50 hours to meet the 500-hour safe harbor. Once this is met, the individual's income from the trade or business will not be included in his net investment income because he is an active participant.

- Consider using a corporation to shelter private equity investments. The double tax that accompanies a corporate structure may eliminate these benefits

- If investing through an S corporation, pay active shareholders decreased compensation to the extent permitted by law
  Illustration: An active S corporation has net income of $900,000. An individual owns 50% of the corporation. The corporation pays the individual owner $300,000 to manage the company. The individual pays the 0.9% tax on the wages over the threshold, but has no additional investment income because he actively participates and additional earnings are not distributed. By decreasing the salary to $200,000, many practitioners believe that the individual will not pay the 0.9% because he falls below the $200,000 threshold. Further, many practitioners believe his active income from the corporation will generally not be included in net investment income.
  Caveat: The IRS can challenge compensation as unreasonably low.

- Sell and distribute stocks with gains before the tax takes effect in 2013, and use losses to the extent possible to decrease net gain. Taxpayers may want to sell even sooner to take advantage of the 15% capital gain rate in 2010.

- Convert a passive pass-through entity to a non-pass-through entity.

Unanswered Questions

Many questions remain unanswered. For example, S corporations making tax distributions will have to make a larger tax distribution to passive investors than to active investors to pay the additional tax.

Passive losses can shelter investment income, and can be carried forward. However, it is unclear whether losses from before the provision goes into effect in 2013 may be carried forward.

The burden to collect the tax is mixed between the employee and the employer. This may make the tax complicated to collect and enforce.