

New 3.8% Medicare Tax on Net Investment Income

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I. Basic Medicare Tax Rules

- A. Wages are subject to 6.2% FICA tax on the first \$113,700 of wages.
- B. Wages are subject to 1.45% Medicare taxes on all wages.
- C. FICA and Medicare taxes are imposed on both the employer and the employee.
- D. Self-employment tax of 15.3% is imposed on the first \$113,700 of self-employment income and 2.9% on the balance of self-employment income.

II. 2010 Health Care Act Added an Additional 0.9% Medicare Tax on Wages and Self-Employment Income Over Threshold Amount

- A. Effective for tax years beginning after December 31, 2012.
- B. Threshold amounts –
 - 1. \$250,000 for married taxpayers.
 - 2. \$200,000 for single taxpayers.
 - 3. \$125,000 for married taxpayers filing separately.
- C. Additional tax is imposed on the employee only.
- D. If tax is not withheld, it is paid with income tax return.
- E. Tax is not dedicated to Medicare; taxes go to general revenue.

III. 3.8% Tax on Net Investment Income

- A. Tax is imposed on the lesser of (i) net investment income or (ii) the modified adjusted gross income in excess of the threshold amount.
 - 1. Threshold amount is the same as for the additional Medicare tax on wages.
 - 2. Threshold amounts for trusts and estates in breakpoint for highest tax rate for trust and estates, i.e. \$11,950.
- B. Net investment income defined.
 - 1. The sum of:
 - a. Gross income from interest, dividends, annuities, royalties and rents;
 - b. Other gross income from a trade or business to which the tax applies; and
 - c. Net gain from the disposition of property (i.e., capital gain).
 - 2. Less deductions allocable to the gross income or net gain.
- C. Net investment income does not include income derived in ordinary course of trade or business, if the trade or business –
 - 1. Does not constitute a passive activity with respect to the taxpayer, and
 - 2. Does not constitute trading in financial instruments or commodities.

- D. A passive activity is one in which the taxpayer does not materially participate. A taxpayer “materially participates” if –
1. The taxpayer as more than 500 hours of participation in the tax year, or
 2. Substantially all participation in the activity is by the taxpayer, or
 3. The taxpayer as more than 100 hours of participation in the tax year and no one else participates more, or
 4. Multiple significant participation activities of aggregating 500 hours with at least 100 hours in this activity, or
 5. Material participation in the activity in 5 of the last 10 years, or
 6. Material participation in a personal service activity where capital is not a material income producing factor, or
 7. Regular, continuous and substantial involvement (facts and circumstances).
- E. Net investment income does not include the following:
1. Income from an active trade or business.
 2. Distributions from qualified retirement plans or IRAs.
 3. Municipal bond income.
 4. Income exempt from tax, such as section 121 gain on sale of a residence, section 1031 gain, and section 1042 rollover amounts.
 5. Net gain from sale of an active trade or business.

IV. Planning for the Tax on Net Investment Income

- A. Use an S corporation for operation of a closely held business.
1. An LLC taxed as an S corporation will qualify.
 2. S corporation distributions are not treated as wages or net investment income and will not be subject to 3.8% tax.
- B. Determine whether it is possible to increase participation in an otherwise passive activity.
1. Use caution if passive income is being used to offset other passive losses.
- C. Trusts should distribute NII to lower bracket beneficiaries or restructure investments to avoid NII.



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