

# Understanding the Additional Medicare Tax and Medicare Surtax on Net Investment Income

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The IRS began accepting 2013 tax returns today. Over the past year, there has been a lot of debate about the impact of the 0.9% Additional **Medicare Tax** and the 3.8% Medicare surtax on net investment income ("surtax"), but taxpayers may not have paid much attention to the new taxes...until now.

The Additional Medicare Tax and surtax both took effect on January 1, 2013 and they are provisions from the Patient Protection and **Affordable Care Act**. Medicare taxes are nothing new; taxpayers already pay a 1.45% tax on their earned income to Medicare. The Additional Medicare Tax imposes an additional 0.9% tax on a taxpayer's earned income above a threshold amount. The threshold amounts based on filing status for 2013 for the Additional Medicare Tax are as follows:

- \$200,000 for single filers;
- \$250,000 for married filing jointly;
- \$200,000 for head of household (with qualifying person);
- \$200,000 for qualifying widow(er) with dependent child;
- \$125,000 for married filing separately.

The surtax, on the other hand, is a new add-on tax for high income taxpayers. The surtax applies to unearned (i.e., investment) income of individuals, trusts and estates with modified adjusted gross income ("MAGI") above a threshold amount.

The threshold amounts based on filing status for 2013 for the Medicare surtax on net investment income are as follows:

- \$200,000 for single filers;
- \$250,000 for married filing jointly;
- \$200,000 for head of household (with qualifying person);
- \$250,000 for qualifying widow(er) with dependent child;
- \$125,000 for married filing separately.

For individuals, the surtax is imposed on the *lesser* of the taxpayer's:

- Net investment income for the tax year; or,
- The amount by which a taxpayer's MAGI exceeds the threshold amount in that year.

While taxpayers in the 39.6% tax bracket could pay a top rate of 43.4% with the surtax in 2013, taxpayers with little to zero unearned income will likely not be affected by the surtax.

## **A couple of examples to illustrate:**

David, a single taxpayer, has earned income of \$150,000 in 2013. He also has \$75,000 of net investment income. Assuming David has no other adjustments that impact MAGI, David's MAGI (the sum of his earned income plus net investment income) is \$225,000. His threshold for both the Additional Medicare Tax and surtax, as a single filer, is \$200,000. Because David's earned income is less than the \$200,000 threshold amount, David will not be impacted by the 0.9% Additional Medicare Tax. However, because David has excess MAGI of \$25,000 above the threshold amount ( $\$225,000 - \$200,000 = \$25,000$ ), David will pay the 3.8% surtax on the lesser of his investment income or excess MAGI. Because David's excess MAGI is less than his net investment income, the surtax is applied to David's excess MAGI of \$25,000.

John, a single taxpayer, has earned income of \$300,000 in 2013 and \$0 of net investment income. Assuming John has no other adjustments that impact MAGI, John's MAGI (the sum of his earned income plus net investment income) is \$300,000. His threshold for both the Additional Medicare Tax and surtax, as a single filer, is \$200,000. Because John's earned income is above the \$200,000 threshold amount, John will pay 0.9% of Additional Medicare Tax on \$100,000 ( $\$300,000$  earned income -  $\$200,000$  threshold amount). For surtax purposes, John has excess MAGI of \$100,000 above the threshold amount ( $\$300,000 - \$200,000$ ), so John will pay the 3.8% surtax on the lesser of his investment income or excess MAGI. Because John's net investment income is \$0, John will not pay any surtax.

Trusts and estates face a potentially larger burden as the surtax is generally imposed on the lesser of:

- The undistributed net investment income for the tax year; or,
- The excess of the taxpayer's adjusted gross income over the dollar amount at which the highest tax bracket begins. This threshold amount is \$11,950 for 2013 and \$12,150 for 2014.

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