Planning for the New Health Care Act 2013 Medicare Taxes

The health care reform legislation enacted in 2010 significantly broadens the Medicare tax base for higher-income taxpayers by enacting two new taxes. Beginning in 2013 higher-income taxpayers will be subject to an additional 0.9% tax on earned income and a new 3.8% tax on investment income. This segment reviews these new taxes and discusses tax planning strategies associated with them.

Additional hospital insurance tax on earned income. Effective for tax years beginning after Dec. 31, 2012, an additional 0.9% hospital insurance (HI) tax is imposed on wages in excess of $250,000 for married taxpayers filing a joint return, $125,000 for married taxpayers filing separately, and $200,000 in all other cases (i.e., single or head of household). (Code Sec. 3101(b)(2)) An additional 0.9% HI tax is also imposed on an individual's net earnings from self-employment (NEFSE) in excess of the above threshold amounts. (Code Sec. 1401(b)(2))

When a taxpayer has both wages and NEFSE, the threshold amount for NEFSE is reduced (but not below zero) by the amount of wages taken into account in determining the additional tax on wages. The net effect of reducing the NEFSE threshold by wages taken into account in determining the additional tax on wages is to subject the total amount of earned income (wages and NEFSE) in excess of the appropriate threshold to the additional tax.

In essence, the additional tax on wages increases the employee portion of HI tax to 2.35% (1.45% + 0.9%) for taxpayers with earned income in excess of the threshold amount, even though the employer matching tax remains unchanged at 1.45%. The net effect of the additional tax on NEFSE is to increase the HI tax on NEFSE to 3.8% (2.9% + 0.9%) for taxpayers with earned income in excess of the threshold amount.

The additional tax on wages is imposed only on employees. Unlike the regular HI tax, there is no employer match.

Although employers are not subject to the matching excise tax, they do have a withholding obligation and are liable for the tax if they fail to withhold the required tax from employees. Employers are required to withhold the additional 0.9% HI tax on wages in excess of $200,000. Wages received by a spouse are not considered in determining the appropriate withholding. The withholding obligation applies only to wages in excess of $200,000, even though the tax may apply to wages at or below $200,000. (Code Sec. 3102(f)(1))

Unlike the 1.45% HI tax, which is applied separately to wages earned by each spouse, the new 0.9% HI tax is imposed on combined wages in excess of $250,000 for married taxpayers filing a joint return. Because the $250,000 threshold for married taxpayers is less than twice the $200,000 threshold for unmarried taxpayers, married taxpayers are potentially subject to a "marriage penalty."

The threshold amounts for the additional HI tax are not adjusted for inflation. Therefore, it is likely that more taxpayers will become subject to this tax in the future.

New HI tax on net investment income. Effective for tax years beginning after Dec. 31, 2012, higher-income taxpayers with investment income will be subject to a new 3.8% unearned income Medicare contributions tax (UIMCT) on their net investment income. HI tax has traditionally been imposed only on wages and NEFSE. The UIMCT extends HI tax to investment income for the first time.

The UIMCT is imposed on the lesser of (1) net investment income, or (2) the excess of modified adjusted gross income (MAGI) over a threshold amount. (Code Sec. 1411(a)) The threshold amounts are the same as those used for the additional 0.9% HI tax ($250,000 for married couples filing a joint return; $125,000 for married couples filing separately; and $200,000 for all other taxpayers). (Code Sec. 1411(b)) As is the case with the additional 0.9% HI tax, these threshold amounts are not indexed for inflation.

Taxpayers are subject to the UIMCT on the full amount of net investment income only if their MAGI exceeds the threshold amount by at least the amount of net investment income. Taxpayers can be subject to both the additional 0.9% HI tax on earned income and the UIMCT in the same year.

MAGI is defined as adjusted gross income increased by foreign earned income or housing costs excluded from income under Code Sec. 911, reduced by deductions attributable to the excluded income. (Code Sec. 1411(d)) Net investment income is defined as the excess of the sum of the following items less deductions properly allocable to such items:

- Gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the UIMCT tax does not apply;
- Income from a trade or business to which the UIMCT tax applies; and
- Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the UIMCT does not apply. (Code Sec. 1411(c)(1))

The UIMCT applies to a trade or business that is a passive activity (as defined in Code Sec. 469) with respect to the taxpayer, and the trade or business of trading in financial instruments or commodities (as defined in Code Sec. 475(e)(2)). (Code Sec. 1411(c)(2)) As a result, business income from an activity that is passive with respect to the taxpayer is considered investment income for purposes of the UIMCT.

The tax does not apply to active trade or business activities conducted by a sole proprietor, partnership, or S corporation. Income from active business activities, however, is included in NEFSE and therefore subject to the additional 0.9% HI tax.

Investment income includes income from the investment of working capital. (Code Sec. 1411(c)(3)) In the case of the disposition of an interest in a partnership or S corporation, gain from the disposition is included in net investment income only to the extent of the net gain the transferor would take into account if the partnership or S corporation sold all of its assets for fair market value immediately before the disposition. (Code Sec. 1411(c)(4))

Distributions from the following retirement plans are excluded from net investment income:

- Qualified pension, profit-sharing, and stock bonus plans under Code Sec. 401(a).
- Qualified annuity plans under Code Sec. 403(a).
- Qualified annuity plans for tax-exempt organizations under Code Sec. 403(b).
- Individual retirement accounts (IRAs) under Code Sec. 408.
- Roth IRAs under Code Sec. 408A.
- Deferred compensation plans of state and local governments and tax-exempt organizations under Code Sec. 457. (Code Sec. 1411(c)(5))

Estates and trusts are subject to the UIMCT. In the case of an estate or trust, the tax is imposed on the lesser of: (1) undistributed net investment income, or (2) the excess of the estate or trust's adjusted gross income (as defined in Code Sec. 67(e)) over the dollar amount at which the highest tax bracket begins. (Code Sec. 1411(a)(2)) Because the highest tax bracket for estates and trusts begins at a relatively low level of income ($11,650 for 2012) (Code Sec. 1(e)), the UIMCT is of particular concern to them.

The UIMCT applies only to the undistributed net investment income of an estate or trust. If an estate or trust makes a distribution to beneficiaries, its undistributed net investment income (and potential liability for the UIMCT) decreases, while the beneficiary's net investment income (and potential liability for the UIMCT) increases. However, because the threshold amount for individuals is much higher than the threshold amount for estates and trusts, a distribution will in all likelihood reduce the overall amount of UIMCT paid.

Tax planning techniques. Tax practitioners should begin planning for the UIMCT now in order to minimize its impact in 2013. The UIMCT, combined with the increase in the top marginal tax rate, will significantly increase the marginal tax rate that higher-income taxpayers pay on investment income.

The UIMCT applies only to taxpayers with both MAGI above the threshold amount and net investment income. As a result, taxpayers can minimize its impact by minimizing either MAGI or net investment income (or both). Tax planning strategies include:

- **Income recognition and deferral planning.** Items of income that are excluded from income reduce both MAGI and net investment income. This provides higher-income taxpayers potentially subject to the UIMCT additional incentive to structure transactions that result in either tax-exempt or tax-deferred income.

  Higher-income taxpayers can minimize the UIMCT by including non-dividend paying growth stocks, which do not increase MAGI or create investment income until sold, in their investment portfolio. Tax-deferred annuities and related investments will also minimize liability for the UIMCT, and may become more popular. Because tax-exempt income is not included in either MAGI or investment income, higher-income taxpayers will have increased incentive to invest in exempt state and local obligations.

- **Capital gain planning.** Investment income includes net gain (to the extent taken into account in computing taxable income) from the disposition of property. (Code Sec. 1411(c)(1)(iii)) Tax planning strategies that reduce or defer capital gain income will also reduce or defer net investment income for purposes of the UIMCT.

  Using the installment method of accounting to report gain on the sale of property sold on an installment basis, for example, will minimize the impact of the UIMCT because it avoids a large increase in both MAGI and investment income in the year of sale. Taxpayers selling property on an installment basis in 2012, however, should consider electing out of the installment method and recognizing the entire amount of the gain before the UIMCT goes into effect.

- **Retirement income planning.** Because distributions from qualified retirement plans are not included in net investment income, the UIMCT provides taxpayers with additional incentive to maximize retirement plan contributions. Although retirement plan distributions are not included in net investment income, distributions that are included in income (such as those from a traditional IRA or 401(k)) increase MAGI. This increase in MAGI may increase the amount of other investment income subject to the UIMCT.

  On the other hand, retirement plan distributions that are not included in income (such as those from a Roth IRA or Roth 401(k)) do not increase MAGI. This provides higher-income taxpayers with incentive to contribute to Roth-type retirement plans, rather than traditional plans. Contributions to traditional retirement plans reduce MAGI in the year of contribution, while contributions to Roth plans do not. Taxpayers with MAGI near the threshold level may be able to avoid or reduce current year's UIMCT by contributing to a traditional plan and reducing MAGI below the threshold.

- **Passive activity loss planning.** Tax practitioners should consider the UIMCT in planning for passive activities. Passive income is investment income for purposes of the UIMCT. Classifying income as passive is generally advantageous for taxpayers with sufficient passive losses to offset the passive income. For taxpayers with net passive income, however, the UIMCT increases the tax rate on passive income.

- **Estate planning.** The UIMCT provides higher-income taxpayers with an incentive to consider the use of family limited partnerships and related estate planning techniques. Investment income transferred from parents with significant MAGI and investment income to children with MAGI below the applicable threshold amount through the use of family limited partnerships will not be subject to the UIMCT.

  Although investment income transferred to children through a family limited partnership may be taxed at their parent's rate under the "kiddie tax" rules, the children will be subject to the UIMCT only if their

income (including income from a family limited partnership) exceeds the applicable threshold.

Children subject to the kiddie tax are taxed at their parent's rate for purposes of the regular tax imposed by Code Sec. 1. (Code Sec. 1(g)(1)) Because the UIMCT is imposed under Code Sec. 1411, rather than Code Sec. 1, children will not be subject to the UIMCT merely because their parents are.

Tax planning for estates and trusts. Estates and trusts with undistributed net investment income will be subject to the UIMCT whenever their adjusted gross income exceeds the dollar amount at which the top marginal tax rate begins. Because the top marginal rate for estates and trusts begins at a relatively small amount of income ($11,650 in 2012), the UIMCT is of particular concern to estates and trusts and should be considered in both distribution and investment decisions.

Estates and trusts are subject to the UIMCT only if they have undistributed net investment income. Estates and trusts can reduce undistributed net investment income and thereby minimize or eliminate the UIMCT by distributing income to beneficiaries.

Any distribution will increase the beneficiary's net investment income and potential liability for the UIMCT. However, the threshold amount for individuals is much higher than that for estates and trusts, and the UIMCT can be eliminated if the beneficiary's MAGI remains below the threshold amount.

Estates and trusts should also consider the UIMCT in making investment decisions. The UIMCT increases the already existing incentives estates and trusts have to invest in tax-exempt and tax-deferred investments.

Final Regs Explain Health Care Law's Post-2013 Health Insurance Premium Tax Credit

IRS has issued final regs on the Code Sec. 36B health insurance premium tax credit, which was enacted as part of 2010 health reform legislation and is scheduled to go into effect in 2014. The regs provide guidance to individuals who enroll in qualified health plans through Affordable Insurance Exchanges and claim the credit, and to Exchanges that make qualified health plans available to individuals and employers. The regs are effective on May 23, 2012.

> **Observation.** The Supreme Court may reject Code Sec. 36B, and possibly the 2010 health care legislation in its entirety, if it rules in June that the individual mandate (i.e., the post-2013 requirement for individuals to carry minimum essential health care coverage) is unconstitutional. Nevertheless, IRS and employers must make plans under current law and assume that the legislation will go into effect as scheduled.

Following is an overview of how the Code Sec. 36B tax credit will work, as explained in the final regs, along with a description of how employers and employer plans will be affected by the credit.

Purpose and operation of Code Sec. 36B credit. The Code Sec. 36B credit is designed to make health insurance affordable to taxpayers whose household income for the tax year is between 100% and 400% of the federal poverty level (FPL), who cannot be claimed as a dependent by another taxpayer, and who are not eligible for other qualifying coverage, such as Medicare, or "affordable" employer-sponsored health insurance plans. (Code Sec. 36B(c)(1)(A)) Married taxpayers who do not file a joint return are also not allowed a premium tax credit under Code Sec. 36B(c)(1)(C). Eligibility for other coverage is determined on a month-by-month basis.

Here is how the Code Sec. 36B credit is designed to work: