

The Contemporary Tax Journal

Volume 1
Issue 1 *Winter 2011 (Inaugural Issue)*

Article 2

1-2011

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Recommended Citation

Jin, Huan (2011) "New Medicare Contribution Tax on Investment Income," *The Contemporary Tax Journal*: Vol. 1 : Iss. 1 , Article 2.
Available at: <http://scholarworks.sjsu.edu/sjsumstjournal/vol1/iss1/2>

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New Medicare Contribution Tax on Investment Income

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The Health Care and Education Reconciliation Act of 2010 was signed into law by President Obama on March 30, 2010. It contains a new provision that will subject certain individuals, estates and trusts to a new 3.8% Medicare contribution tax beginning in 2013.

Background

Federal taxes imposed on wages of employees include the OASDI tax and the Medicare Hospital Insurance tax. Before the 2010 Reconciliation Act, there was no Medicare tax levied on unearned income. Unearned income is income from investments, such as interest, dividends and capital gains. The imposition of a 3.8% Medicare contribution tax on unearned income along with an increase in the Medicare Hospital Insurance tax on high-income employees and self-employed individuals, both commencing January 1, 2013, will generate revenue to help finance reforms under the health care legislation.

Explanation

Who will be taxed?

Generally, an individual taxpayer with some net investment income and modified adjusted gross income (MAGI)¹ above the applicable threshold amount will be subject to the new tax. The threshold amounts are:

- | | |
|---------------|---|
| (1) \$250,000 | For a taxpayer filing a joint return and a surviving spouse |
| (2) \$125,000 | For a married taxpayer filing separately |
| (3) \$200,000 | For other taxpayers (e.g. a taxpayer filing as single) |

Trusts with gross income above the dollar amount at which the highest estate and trust income tax bracket begins for the tax year (e.g. \$11,200 for 2010) will be taxed. Certain types of trusts are exempted from the tax.²

What is included in net investment income?

Net investment income is the investment income reduced by the deductions applicable to such income.

Investment income is comprised of non-business income from interest, dividends, annuities, royalties, rents and capital gains. Income derived from an active trade or business, such as rental income of real estate professionals, is not included, but passive activity income is included. A business of trading financial instruments or commodities is not treated as an active trade or business, thus the income derived from such trade or business will be included in investment income.

Net investment income excludes any distribution from qualified pension, profit-sharing and stock bonus plans, qualified annuity plans, annuities for employees of tax-exempt organizations or public schools, IRAs, Roth IRAs and deferred compensation plans of state and local governments and tax-exempt organizations.

¹ MAGI is gross income including foreign earned income reduced by some enumerated deductions.

² For details of the new Medicare tax, see Internal Revenue Code Section 1411 and information on the IRS website.

How to calculate the Medicare contribution tax

➤ For individuals

- ✧ Step 1 - Calculate the amount of the net investment income for the tax year.
- ✧ Step 2 - Calculate the amount of MAGI for the tax year.
- ✧ Step 3 – Subtract the threshold amount from step 2.
- ✧ Step 4 - Choose the smaller of step 1 and step 3 and multiple by 3.8%.

➤ For estates and trusts

- ✧ Step 1 - Calculate the amount of the undistributed net investment income for the tax year.
- ✧ Step 2 - Calculate the amount of adjusted gross income (AGI) for the tax year.
- ✧ Step 3 – Subtract the highest estate and trust income tax brackets in begins for the tax year from step 2.
- ✧ Step 4 – Choose the smaller of step 1 and step 3 and multiple with 3.8%.

Examples

(1) In 2013, Sue, a single taxpayer, earns \$100,000 in net investment income. Sue’s MAGI is \$150,000.

- ✧ Step 1 - Sue’s net investment income is \$100,000.
- ✧ Step 2 - Sue’s MAGI is \$150,000.
- ✧ Step 3 - The excess of MAGI over threshold amount is 0. (\$150,000-\$200,000)
- ✧ Step 4 - Choose the lesser of \$100,000 and \$0 then multiple by 3.8%.

Sue will incur no Medicare contribution tax in 2013.

(2) Same as Example (1), above, except Sue’s MAGI is \$250,000.

- ✧ Step 1 - Sue’s net investment income is \$100,000.
- ✧ Step 2 - Sue’s MAGI is \$250,000.
- ✧ Step 3 - The excess of MAGI over threshold amount is \$50,000. (\$250,000-200,000)
- ✧ Step 4 - Choose the lesser of \$100,000 and \$50,000 then multiple by 3.8%.

Sue will incur a \$1,900 (3.8 % x \$50,000) Medicare contribution tax in 2013. With Sue’s MAGI increasing, the Medicare contribution tax Sue owes will also increase. Moreover, only when the dollar amount of MAGI is larger than the applicable threshold amount, is an individual subject to the Medicare contribution tax.

When is the effective date?

The Medical contribution tax starts on January 1, 2013.

Summary

A new provision enacted as part of the 2010 health care legislation will impose a Medicare contribution tax on high-income individuals, estates and trusts beginning in 2013. As time goes by, more individuals will be subject to the tax because the applicable threshold amounts for individuals are not adjusted annually for inflation. While the tax is not effective until 2013, it should be considered in tax planning decisions that affected taxpayers make today.

