

The New 3.8% Tax on "Unearned Income"

Effective for taxable years beginning after December 31, 2012, an unearned income Medicare contribution tax is imposed on individuals, estates, and trusts. In the case of an individual, the tax is the 3.8% of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case. Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (ii) other gross income derived from any business to which the tax applies, and (iii) ***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 tax does not apply.***

In the case of a trade or business, *the tax applies if the trade or business is a passive activity with respect to the taxpayer* or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation. In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account. Income, gain, or loss on working capital is not treated as derived from a trade or business. Investment income does not include distributions from a qualified retirement plan or amounts subject to SECA tax.

Under current law the tax on Net Earnings from Self Employment ("NESE") only applies to an employee's wages and a self-employed individual's self-employment income. Beginning January 1, 2013, the Health Care Act will impose, for the first time, an additional Medicare tax of 3.8% on certain "net investment income" of taxpayers with adjusted gross income exceeding certain thresholds. The manner in which this new tax applies is not intuitive.

As a threshold inquiry, one must first determine whether the new tax will apply to a particular taxpayer. With respect to individuals, the new Medicare tax would apply only to individuals with adjusted gross income greater than \$200,000 per year (\$250,000 per year for married couples filing jointly).¹

Once it is determined that the new tax will apply, one must determine which income is subject to the tax. If applicable, the new Medicare tax will apply to the lesser of (i) all of a taxpayer's "net investment income," or (ii) a taxpayer's adjusted gross income in excess of \$200,000 (or \$250,000 for married couples filing jointly). For these purposes, "net investment income" generally will include interest, dividends, royalties, rents, and gains from the sale of

property, excluding, in each instance, income derived in the ordinary course of an active trade or business. Importantly, this new tax does not apply to, among others, (i) items of income taken into account in determining self-employment income, (ii) income in tax-deferred retirement accounts, such as 401(k)s, or (iii) tax-exempt income (e.g., interest from tax-exempt bonds).

Example #1: In 2013, a single individual has (i) net investment income of \$100,000, and (ii) adjusted gross income of \$290,000. Importantly, the individual's adjusted gross income of \$290,000 exceeds the threshold amount of \$200,000 by \$90,000. Because the \$90,000 adjusted gross income in excess of the threshold amount is less than the \$100,000 net investment income, the new Medicare tax only applies to the \$90,000 adjusted gross income in excess of the threshold amount. As such, the individual's new Medicare tax would be \$3,420 (i.e., \$90,000 x 3.8%).

Example #2: In 2013, a single individual has (i) net investment income of \$100,000, and (ii) adjusted gross income of \$310,000. Importantly, the individual's adjusted gross income of \$310,000 exceeds the threshold amount of \$200,000 by \$110,000. Because the \$100,000 net investment income is less than the \$110,000 adjusted gross income in excess of the threshold amount, the new Medicare tax only applies to the \$100,000 net investment income. As such the individual's new Medicare tax would be \$3,800 (i.e., \$100,000 x 3.8%).

ⁱ This new tax also applies to estates and trusts, but this article's focus is on individuals.