Medicare Taxes for Higher-income Taxpayers

Facts and planning considerations to help manage your tax liability

Begin planning now

You'll especially want to discuss these tax provisions with your financial advisor and tax advisor if you:

- Have substantial dividend or interest income in a taxable account
- Generate large taxable capital gains
- Have unusually high income for a given year
- Plan to do a Roth IRA conversion

If you are a higher-income taxpayer, you are likely paying more taxes because of these two key tax provisions:

- A 0.9% increase in Medicare payroll taxes on earned income (including net self-employment income) above $200,000 (individual filers) or $250,000 (married/joint filers)
- A 3.8% Medicare surtax on the lesser of net investment income or the excess if your modified adjusted gross income (MAGI)* exceeds the above thresholds

Calculating the amount of additional taxes you may owe will be complex because multiple calculations may be required. (To understand what is involved, see the examples on page 4.)

Net Investment Income and Medicare tax rate summary

Thresholds for these taxes†	
Single:	$200,000
Married filing jointly:	250,000

Employee compensation *Medicare wages as reported on IRS Form W-2*	**Current rate**
Employee's tax rate up to threshold	1.45%
Employee's tax rate in excess of threshold	2.35
Employer's tax rate (no threshold)	1.45
Self-employment income *Net self-employment income as determined on IRS Form 1040 Schedule SE*	
Self-employed individual's tax rate up to threshold	2.90
Self-employed individual's tax rate in excess of threshold	3.80
Net investment income *Compare threshold to your MAGI as determined on IRS Form 8960*	
Investor's tax rate up to threshold	0.00
Investor's tax rate in excess of threshold	3.80

** MAGI is your adjusted gross income shown on page 1 of IRS Form 1040 plus any foreign income or foreign housing costs that were excluded from your income. If you own a controlled foreign corporation or a passive foreign investment company, additional adjustments to MAGI may be required.*

† These thresholds are not indexed for inflation. An increasing number of taxpayers could be subject to this tax increase as inflation boosts wages over time.

Investment and Insurance Products: ▶ NOT FDIC Insured ▶ NO Bank Guarantee ▶ MAY Lose Value

Understanding the Medicare tax on earned income

Employers are required to withhold additional Medicare taxes once an employee's earned income exceeds $200,000 without regard to the individual's filing status or wages paid by another employer. However, if you are married and both you and your spouse are highly compensated, the amounts your respective employers withhold may not cover your total tax bill. This could leave you unexpectedly owing additional taxes and penalties when you file your return. Consider this example:

> Spouse A earns $200,000 and Spouse B earns $100,000. Each of their employers views its employee as having earnings at or below the $200,000 applicable threshold and, therefore, does not withhold the additional 0.9% tax. However, the couple's combined earnings ($300,000) do, in fact, exceed the threshold. As a result, the couple is subject to the 0.9% tax on the $50,000 excess which will become apparent when they prepare their tax return.

Conversely, married couples filing joint returns with one salary and earnings exceeding $200,000 may overpay on the 0.9% tax. The employer must withhold the additional 0.9% tax based on the salary in excess of $200,000. However, the married couple filing a joint return is subject to the additional tax only on salary in excess of $250,000. The additional tax on amounts in excess of $200,000 but not in excess of $250,000 would result in excess withholding that would be taken into account upon the filing of the couple's income tax return for the year.

If you find yourself in either situation, you'll need to work closely with your tax advisor to determine whether to make quarterly estimated payments or have your employer withhold more or less from regular paychecks.

Self-employed individuals will also have to pay the additional 0.9% tax on their net self-employment income that exceeds the threshold. In general, self-employed individuals are allowed an income tax deduction on one-half of the self-employment taxes paid. However, the Affordable Care Act does not provide a deduction for any portion of the additional 0.9% tax.

What you should do now

To be prepared for the potential additional Medicare taxes, make projections regarding your expected income during the next few years. If you have flexibility in terms of when you receive certain income payments, you may want to consider timing those cash flows accordingly. Keep in mind that the application and timing of Medicare taxes can be complex depending on the type of compensation benefits you receive. Before implementing any planning ideas, talk with your employer and tax advisor.

Three types of investors will particularly want to factor this additional tax in their planning strategies:

Pre-retirees. As you transition into retirement, your compensation may change. You may be gradually reducing your workload and earnings over more than one year. Or your stock-based compensation may continue vesting beyond your retirement year (thus boosting taxable income into future years).

You'll want to factor these tax consequences into the timing of your retirement. You may want to arrange your retirement date to ensure that any sizable income flow occurs in years when your income is expected to fall below the threshold where the additional tax kicks in. If you have an arrangement that allows for income streams over several years, you may want to accelerate or defer that income into a year that will have less investment income.

Employees with sizable company stock benefits. If you are holding nonqualified stock options (NSOs) that will create taxable income when exercised, you'll want to discuss the timing of those exercises with your financial advisor and tax advisor to help reduce the tax liability. As a group, you can develop a strategy that takes into account your outlook for the company stock, the NSO expiration dates, the amount of investment income you expect in a particular year, and your employment compensation.

Self-employed persons. You will want to look particularly at your expected income and expenses. Work closely with your tax advisor to analyze whether you should accelerate or defer certain expenses for a particular tax year to control your taxable income.

Focusing on the tax on net investment income

There are three key points to understand about this tax:

- It is in addition to and calculated separately from your regular tax or alternative minimum tax (AMT) liability.
- The tax applies to the lesser of your net investment income or the excess of your MAGI above the applicable threshold ($200,000 for single filers; $250,000 for joint filers).
- Taxpayers should be aware of how investment income is calculated.
  - Net investment income includes:
    - Taxable interest
    - Dividends
    - Gains (those attributable to disposition of a trade or business may be excluded)
    - Taxable nonqualified annuity distributions
    - Royalties and net rental income
    - Passive income from private business interests and Master Limited Partnerships
  - Net investment income does *not* include:
    - Tax-exempt interest
    - Distributions from IRAs and employer retirement plans
    - Income from a trade or business in which you materially participate
    - Veteran's and Social Security benefits

It's also important to note that there is no provision to automatically withhold this tax. You and your tax advisor need to determine whether you should adjust withholding amounts or begin (or increase) estimated tax payments to avoid underpayment penalties.

What if I have a gain on the sale of my home?

The capital gain from the sale of a principal residence is treated differently from the sale of other real estate holdings.* This capital gain will be subject to tax only if your MAGI exceeds the surtax threshold and the gain is greater than the allowed personal residence exclusion amount (in general, $500,000 for married filing jointly and $250,000 for single).

** Per IRC section 121*

A look at the effect on three taxpayers

Bob and Theresa *(married filing jointly)*

Combined wages *(Under the threshold for the 0.9% earned income tax)*	$230,000
Capital gains	30,000
MAGI *(Over the threshold for the 3.8% investment income tax)*	$260,000

The additional 3.8% tax on net investment income would apply to the lesser of:

Net investment income *or*	$30,000
Excess MAGI over $250,000 threshold	10,000

In this example,
Bob and Theresa will pay 3.8% on $10,000, or an additional tax of $380.

Martha *(single)*

Wages	$180,000
Dividends	20,000
MAGI *(Under the threshold for the Medicare tax on both earned income and investment income)*	$200,000

However, Martha decides to take a fully taxable $30,000 IRA distribution:

IRA distribution	$ 30,000
New MAGI *(Over the threshold for the 3.8% tax on investment income)*	230,000

The additional 3.8% tax on net investment income would apply to the lesser of:

Net investment income *or*	$20,000
Excess MAGI over $200,000 threshold	30,000

In this example,
Martha will pay 3.8% on $20,000, or an additional tax of $760.

It's important to understand that although IRA distributions are excluded from investment income for purposes of calculating the tax, the distributions boost MAGI, which can subsequently subject a taxpayer to the 3.8% Medicare tax.

David and Elizabeth *(married filing jointly)*

Combined wages *(Over the threshold for the 0.9% tax on earned income)*	$350,000
Dividends and capital gains	35,000
MAGI *(Over the threshold for the 3.8% tax on investment income)*	$385,000

The additional 0.9% Medicare tax on earned income would be:

Wages ($350,000)–threshold ($250,000) = $100,000 x 0.9% = $900

The additional 3.8% tax on net investment income would apply to the lesser of:

Net investment income *or*	$ 35,000
Excess MAGI over $250,000 threshold	135,000

In this example,
David and Elizabeth will pay an additional $900 on earned income plus $1,330 on net investment income (3.8% tax on $35,000) for a total additional Medicare tax of $2,230.

As you can see, you and your tax advisor need to pay close attention to both your projected MAGI and net investment income. You'll want to involve both your tax and financial advisors in discussions on realizing capital gains or other types of income as these will affect the calculation of both of these taxes.

Trusts and estates need to pay special attention

Trusts* and estates are also subject to the tax on investment income. However, the tax for these entities is determined differently than for individuals. Trusts and estates are subject to tax on the lesser of their undistributed net investment income for the year or the excess of their adjusted gross income over the applicable threshold.

The threshold for trusts and estates is different than that for individuals; it is based on the level of taxable income that puts the entity into the highest tax bracket—so the threshold is significantly lower than that for individuals. Yearly increases for inflation in tax brackets make it difficult to estimate the amount of taxable income that may subject a trust or estate to the net investment income tax. However, in 2018, $12,500 of income would put a trust or estate account into the highest tax bracket for the entity. Above that level (as indexed for inflation), the entity would be subject to the additional 3.8% tax on investment income.

What you should do now

In preparation for the net investment income tax, begin considering how the investment income you anticipate receiving each year could affect your tax situation. As you, your financial advisor and tax advisor evaluate some of the strategies below, keep in mind that a decision to implement one or more of these ideas should not be based on tax planning alone. You should consider your investment time horizon, risk tolerance, and asset allocation as you weigh each of these strategies. Implementing one or more could have additional financial implications or affect your estate and wealth transfer plans.

Here are four strategies that may minimize your exposure to the 3.8% Medicare tax:

Consider tax-exempt bonds. As noted, tax-exempt interest is excluded from both your MAGI and net investment income calculations. Such income will not push your MAGI over the threshold and make you subject to these taxes. However, you have to weigh this advantage against the effect on your overall asset allocation. Tax-exempt investments have inherent risks, including, but not limited to:

- **Market risk**—your bond investments' principal value will fall if interest rates rise.
- **Inflation risk**—bonds typically do not protect against the rising cost of living.
- **Tax**—certain municipal bonds may expose you to the AMT or state income tax.

Roth conversions. Converting some or all of a traditional IRA or qualified retirement plan to a Roth IRA may reduce your exposure to these taxes in years after the conversion. Tax-free distributions from a Roth IRA are not considered investment income and do not increase your MAGI. Although traditional IRA or qualified plan withdrawals are not considered investment income, such withdrawals increase your MAGI—perhaps subjecting you to these new taxes on other sources of income (as shown in the second example on page 4).

** Certain trusts may be exempt. Consult your tax advisor.*

You can count on us

You'll want to involve your tax and legal advisors and your financial advisor to help you evaluate your financial, investment, and tax situation. Together, you may be able to implement a number of strategies to help you reduce or avoid these Medicare taxes.

If you're considering a Roth conversion, you'll also want to control the timing of such a conversion. Converting to a Roth creates taxable income, and doing so could boost your MAGI to a level that triggers or increases these Medicare taxes. Keep in mind you can convert portions of your traditional IRA or qualified plan over time, thus controlling the taxable income you recognize in any one year and perhaps helping you to reduce or avoid these taxes.

Take advantage of tax-deferred vehicles. You may want to take a second look at your contribution levels to your employer retirement plan or annuities. Income earned in tax-deferred investments is not included in the MAGI calculation for these taxes until it is distributed. In addition, the tax-deferral feature gives you the potential to accumulate more for your retirement.

Time your income recognition. To the extent possible, pay particular attention to when you receive income, generate capital gains, exercise stock options, or take taxable distributions from IRAs or retirement plans. Try to avoid spikes in income that could push your MAGI over the threshold. If you anticipate receiving a sizable payout from your employer, plan for the effect. It may be beneficial to spread the receipt of this payment over multiple years to reduce each year's addition to your MAGI. Or you may find it beneficial to accelerate the income to lessen the effect of a high MAGI in years when investment income may also be high. When considering this strategy, you will need to look at both your employer's flexibility in allowing multi-year payments as well as your employer's financial ability to continue making those payments.

Distribute trust income. For trusts that are required to file a trust income tax return, the Medicare tax can apply at a relatively low threshold. Where possible, consider distributing trust income to trust beneficiaries who are not subject to the Medicare tax in order to reduce the overall tax bill.

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