TAXING HIGH-INCOME TAXPAYERS TO FUND THE MEDICAL CARE SYSTEM

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ABSTRACT

The increased taxes imposed by the Affordable Care Act might be considered nuisance taxes because they increase taxes on personal service earnings by 0.9 percent and impose a new levy on investment income of 38 percent. But, they, especially the 3.8 percent tax on investment income might be enough to generate unexpected planning, especially to the extent they are on top of the current 15 percent, or 20 percent for high income individuals, capital gains tax. This research explores the effect of the 3.8 percent tax and begins to explore planning opportunities.

INTRODUCTION

The Affordable Care Act (ACA) [1] contains two changes that will affect many high-income taxpayers, beginning in 2013. The first change, for high-income taxpayers with earned income in excess of $200,000 ($250,000 for married taxpayers, filing jointly; $125,000 for married taxpayers, filing separately), a 0.9 percent increase in the Medicare tax rate from 2.9 percent to 3.8 percent is intended to help pay for the increased costs of our National Health Care System (NHCS). The second change is an entirely new Medicare surtax on the Net Investment Income (NII) of high-income taxpayers that is also intended to help pay for the increased cost of our NHCS. That tax is also assessed at the rate of 3.8 percent and is often popularly referred to, although currently not so popular, as the Obama care tax. For purposes of this tax, NII includes dividends, interest, capital gains, rental or royalty income, as well as passive income from partnerships, Sub "S" Corporations and LLCs that are treated as partnerships. The tax is assessed on the smaller of the total NII or excess income greater than the income thresholds, described above. For purposes of calculating any applicable Medicare tax, there is a new Form 8960, Net Investment Income Tax--Individuals, Estates and Trusts.

CALCULATING THE NET INVESTMENT INCOME TAX

The additional Medicare tax on earned income in the form of salaries or wages will be collected by the employer, when the total paid to any individual exceeds $200,000 for that year. Therefore, this withholding does not establish the final liability for the tax. For example, if the employee is married, filing a joint return, no liability is incurred until the joint earned income exceeds $250,000. On the other hand, if both spouses earn exactly $200,000 each, no withholding would have taken place by the employer, but they would still be liable for the

increased .9 percent on the combined earned income in excess of $250,000. In the first instance they would have a refundable credit of the additional tax withheld. In the second situation, they would owe and have to pay the additional tax, either through estimated tax payments, or when they file their tax return.

The Medicare surtax on NII in calculated on the smaller of NII or the amount by which Modified Adjusted Gross Income (MAGI) exceeds the income thresholds. For example, Christopher is a single taxpayer with an MAGI of $245,000, consisting of $180,000 in wages, and $65,000 in net investment income from interest, dividends and passive income from an "S" corporation. $45,000 is subject to the Medicare surtax which is determined by subtracting the $200,000 threshold amount from the $245,000MAGI. When comparing the excess income of $45,000 to the net investment income of $65,000, the excess income is lower; therefore the excess income of $45,000 will be subject to the 3.8 percent Medicare surtax.

FOREIGN EARNED INCOME EXCLUSION

For purposes of calculating the Medicare surtax, MAGI is Adjusted Gross Income (AGI) increased by the excess of:

1. The income excluded under Code Sec. 911(a)(1), foreign earned income exclusion, over

2. Any deductions (if taken into account in computing AGI) or exclusions with respect to the excluded income in (1) that are disallowed under Code Sec 911(d)(6).

Therefore, for most taxpayers MAGI will simply be their AGI. However, the following example demonstrates a situation where the modification does apply.

H and W are married and will file a joint federal tax return for 2013. They estimate that their combined 2013 income and deductions will include:

- H's wages of $95,000 as a truck driver in Iraq and ($15,000) of travel expenses.
- H's taxable pension of $100,000.
- H's mandatory withdrawal from an IRA (or 401(k) or 403 (b) plan) of $50,000.
- H's Social Security retirement benefit of $30,000.
- H's military disability compensation of $12,000.
- W's salary of $275,000, subject to a before tax matching of 12 ½ percent contribution to a 403(b) plan; a net taxable amount of $240,625.
- Dividend, interest, and net rental income of $100,000.
- Net self-employment loss from farming of ($50,000).
- Net self-employment profit from consulting of $75,000.

Because H was out of the country for at least 330 days during this continuous 12 month period, H and W will elect to exclude this income under Code Sec 911(a)(1). Because the income had

been excluded, the related travel expenses will not be deductible for purposes of calculating their U. S. federal tax liability.

The $12,000 of military disability compensation is fully excludable (Section 1411) and will not appear on their tax return or as an adjustment in the calculation of the Medicare surtax.

W's salary of $275,000 will be reduced by the 12 ½ percent contribution to a 403(b) plan with only the remaining $240,625 subject to income and FICA taxes. Because it exceeds the $200,000 base, W's employer will have withheld not only the normal medicare tax of 2.9 percent on the entire amount but, also, the .9 percent on the $40,625 above the base of $200,000.

The calculation of the Medicare tax on their combined earned income will exclude the foreign earned income of $95,000 but will include the self-employment income of $75,000 and the self-employment loss of ($50,000); ($240,625 + $75,000 - $50,000 = $265,625.) The normal tax will be $7,703 (.029*265,625). The additional tax will be $141 (.009*(265,625-250,000).

For purposes of the Medicare tax on NII, MAGI will be calculated adding to AGI the $95,000 of excluded foreign earned income less the disallowed travel expenses of $15,000, as show in the following illustration.

AGI AND MAGI

W's salary, net of 403(b) match	$240,625
H's pension	100,000
H's mandatory IRA withdrawal	50,000
H's taxable social security retirement benefit (85%*$30,000)	25,500
Joint self-employment income from consulting	75,000
Joint self-employment loss from farming	(50,000)
Joint net investment and rental income	100,000
Adjusted Gross Income	$560,625
Add back excluded foreign earned income	95,000
Less disallowed travel expenses	(15,000)
Modified Adjusted Gross Income	$640,626

Therefore, the Obamacare tax will be $3,800 (.038*100,000). Although MAGI exceeds the $250,000 by $290,625, only the net investment and rental income is subject to this new tax. If we were to increase the farm loss to ($300,000), reducing MAGI to $340,625, only $90,625 340,625-250,000) would be subject to the new tax.

The farm loss could be increased from ($50,000) to ($300,000) by buying $250,000 of new equipment that would qualify under Code Sec. 179 to be written off in the current year.

THE NEW POTENTIAL MARRIAGE PENALTY

An interesting example involving Helen and John, married with no children, and each of them has a salary of $150,000 and $50,000 of NII, results in a marriage penalty $4,250.

	Helen Single	John Single	Married
Earned Income	$150,000	$150,000	$300,000
.9% Medicare Tax	-0-	-0-	$ 450
Net Investment Income	$ 50,000	$ 50,000	$100,000
Modified AGI	$200,000	$200,000	$400,000
Excess NII Over The Limit	-0-	-0-	$150,000
Medicare Surtax on NII	-0-	-0-	$ 3,800
Total Marriage Penalty			$ 4,250

PASS-THROUGH ENTITIES

Determining whether income from pass-through entities is investment income for purposes of this tax is critical. It the business activity is a passive activity under Section 469, the business income that flows through is subject to the tax. Any investment income that flows through is also subject to the tax. These determinations can be complex.

With the S corporation, compensation paid to the owners reduces the flow-thru income. As such, the compensation avoids the 3.8% tax on investment income, but could become subject to the 0.9% tax on earnings.

The statute specifically provides that gains attributable to the sale of an active business operated in a pass-through entity are not investment income subject to the 3.8% tax to the extent the assets are used in an active business. However, any gains attributable to other assets are subject to the tax.

PLANNING

The simplest planning for this tax is timing. When, and whether, to make a disposition or other recognition transaction can mean paying, delaying, or avoiding the tax. For some, this is a nuisance tax that will not affect behavior at all. For others, it will be enough to alter their behavior. With the new 20% capital gains tax on high income taxpayers, 3.8% might not feel like a lot, yet for others, it may be enough to stop a sale. Add the effects of state and local taxes, and the burden is even greater.

This tax adds to the consequences of entity selection. The attractiveness of the regular corporation that is not a pass-through entity is different in at least two ways. Corporations generally do not have passive activities, but the gain on the sale of stock is investment income. Caution is therefore important, and long-range planning plays a role.

Donald T. Williamson published an article—'Planning for the "Parallel Universe" of the Net Investment Income Tax'—in the *Tax Adviser* (August 1, 2013), in which he discusses a number of planning considerations. Between now and the WDSI meeting dates, additional planning opportunities/risks will be identified and discussed.

CONCLUSION

The Obamacare taxes had received much attention by upper middle and higher income taxpayers. Since the taxes took effect January 1, 2013, planning is, and should be, underway. Or, do they just pay the tax. This paper has raised the appropriate issues and begins to develop approaches to assessing the amount of tax at issue and managing it.

REFERENCES

[1] *The Patient Protection and Affordable Care Act*, March 23, 2010 [H.R. 3590], Public Law 111-148, 111th Congress.