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TAX PRACTICE ALERT
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2013 Brings New Taxes to High Income Taxpayers

By Jonathan R. Flora

The Patient Protection and Affordable Care Act (sometimes called "Obamacare") comes with two new taxes for higher income taxpayers beginning on January 1, 2013: (i) a 3.8 percent Medicare contribution tax on net investment income ("Net Investment Income Tax"), and (ii) a 0.9 percent additional Medicare tax on wages and self-employment income. This *Alert* provides a general overview of these taxes and some of their potential impacts.

Net Investment Income Tax

This new 3.8 percent tax will only affect taxpayers whose adjusted gross income ("AGI") exceeds $250,000 for joint filers, $200,000 for single taxpayers and heads of household, and $125,000 for a married individuals filing separately. AGI consists of your gross income minus your adjustments to income.

If your AGI is above the threshold that applies to you, the 3.8 percent tax will apply to the lesser of (1) your net investment income for the tax year or (2) the excess of your AGI for the tax year over your threshold amount. This tax will be in addition to the income tax that applies to that same income.

The "net investment income" that is subject to the 3.8 percent tax consists of interest, dividends, annuities, royalties, rents, and net gains from property sales. Income from an active trade or business is not included in net investment income, nor is wage income. However, passive business income is subject to the Net Investment Income Tax. Thus, while rents from an active trade or business are not subject to the tax, rents from a passive activity are subject to it. Income from a business of trading financial instruments or commodities is also included in net investment income.

Income that is exempt from income tax, such as tax-exempt bond interest, is likewise exempt from the Net Investment Income Tax. Thus, switching some of your taxable investments into tax-exempt bonds may reduce your exposure to the 3.8 percent tax.

If you sell your main home, you may be able to exclude up to $250,000 of gain, or up to $500,000 for joint filers, when figuring your income tax. This excluded gain will not be subject to the Net Investment Income Tax. However, gain that exceeds the limit on the exclusion will be subject to the tax. Gain from the sale of a vacation home or other second residence, which does not qualify for the income tax exclusion, will also be subject to the Net Investment Income Tax.

Distributions from qualified retirement plans, such as pension plans and IRAs, are not subject to the Net Investment Income Tax. However, those distributions may push your AGI over the threshold that would cause other types of investment income to be subject to the tax. This makes Roth IRAs more attractive for higher-income individuals, because qualified Roth IRA distributions are neither subject to the Net Investment Income Tax nor included in AGI.

The Net Investment Income Tax must be included in the calculation of estimated tax that you owe. As a result, if you will be subject to the tax, you may have to make or increase your estimated tax payments to avoid a penalty.

Additional 0.9 Percent Medicare Tax on Wage and Self-Employment Income

Also beginning in 2013, some high wage earners will pay an extra 0.9 percent Medicare tax on a portion of their wage income, in addition to the 1.45 percent Medicare tax that all wage earners pay. The 0.9 percent tax applies to wages in excess of $250,000 for joint filers, $125,000 for a married individuals filing separately, and $200,000 for all others. The 0.9 per-

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cent tax applies only to employees, not to employers.

Once an employee's wages reach $200,000 for the year, the employer must begin withholding the additional 0.9 percent tax from the wages. However, this withholding may prove insufficient if the employee has additional wage income from another job or if the employee's spouse also has wage income. To avoid that result, an employee may request extra income tax withholding by filing a new Form W-4 with the employer.

An extra 0.9 percent Medicare tax also applies to self-employment income for the tax year in excess of $250,000 for joint filers, $125,000 for married individuals filing separately, and $200,000 for all others. This 0.9 percent tax is in addition to the regular 2.9 percent Medicare tax on all self-employment income. While self-employed individuals can claim half of their self-employment tax as an income tax deduction, the additional 0.9 percent tax won't generate any income tax deduction. ◆

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For more information on these new taxes and how they may apply to your situation, please contact any of the following members of the Tax Practice Group:

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