The New Medicare Tax and You

Posted: 3/13/2013 by Fidelity Viewpoints

Two new taxes in 2013 may impact high-income earners and investors.

With all the attention focused on the tax changes included in legislation to avert the fiscal cliff, some may have forgotten about the new Medicare taxes that went into effect on January 1, 2013. These taxes will impact many upper income Americans.

First, a new 3.8% Medicare surtax is levied on the lesser of net investment income or the excess of modified adjusted gross income (MAGI) above $200,000 for individuals, $250,000 for couples filing jointly, and $125,000 for spouses filing separately.

Second, wages above $200,000 (individuals) and $250,000 (joint filers) will be subject to higher payroll taxes.

Let's review each one in detail.

Medicare payroll tax increase on earned income

The Medicare payroll tax is 2.9%. It applies only to earned income, which is wages you are paid by an employer, plus tips. You're responsible for 1.45% of the tax, and it's deducted automatically from your paycheck. Your employer kicks in the other 1.45%.

Under the new tax provision, high-wage earners will owe an additional 0.9% on earned income above the thresholds mentioned above. So, for example, if you are an individual filer whose MAGI will be $225,000 in 2013, you will pay a 1.45% Medicare tax on the first $200,000, then 2.35% (1.45% plus 0.9%) on the next $25,000. Your employer will be required to withhold the extra 0.9% once your wages pass the $200,000 threshold for individuals.

Another example: If you're married and you and your spouse each earn $150,000, your employers will withhold 1.45% for Medicare tax, because neither of you exceeds the $200,000 individual threshold. But if you file a joint tax return, your combined earned income of $300,000 is $50,000 above the married filing jointly threshold. This means you will have underpaid your Medicare tax by $450 (0.9% of $50,000) and will owe the additional amount when you file your taxes. Speak to your tax adviser about potentially being required to make estimated tax payments.

New tax on net investment income

In the past, taxpayers weren't required to pay Medicare tax on income generated from investments such as capital gains, dividends, and taxable interest. In 2013, however, you could owe a 3.8% Medicare tax on some or all of your net investment income.

The amount you owe is based on the lesser of your total net investment income or the amount of your MAGI that exceeds $200,000 for individuals, $250,000 for couples filing jointly, or $125,000 for spouses filing separately. By definition, MAGI includes your adjusted gross income (AGI), wages from work, net investment income, qualified distributions from a retirement plan such as a traditional IRA, 401(k), or 403(b), and any foreign earned income exclusion you may have had.

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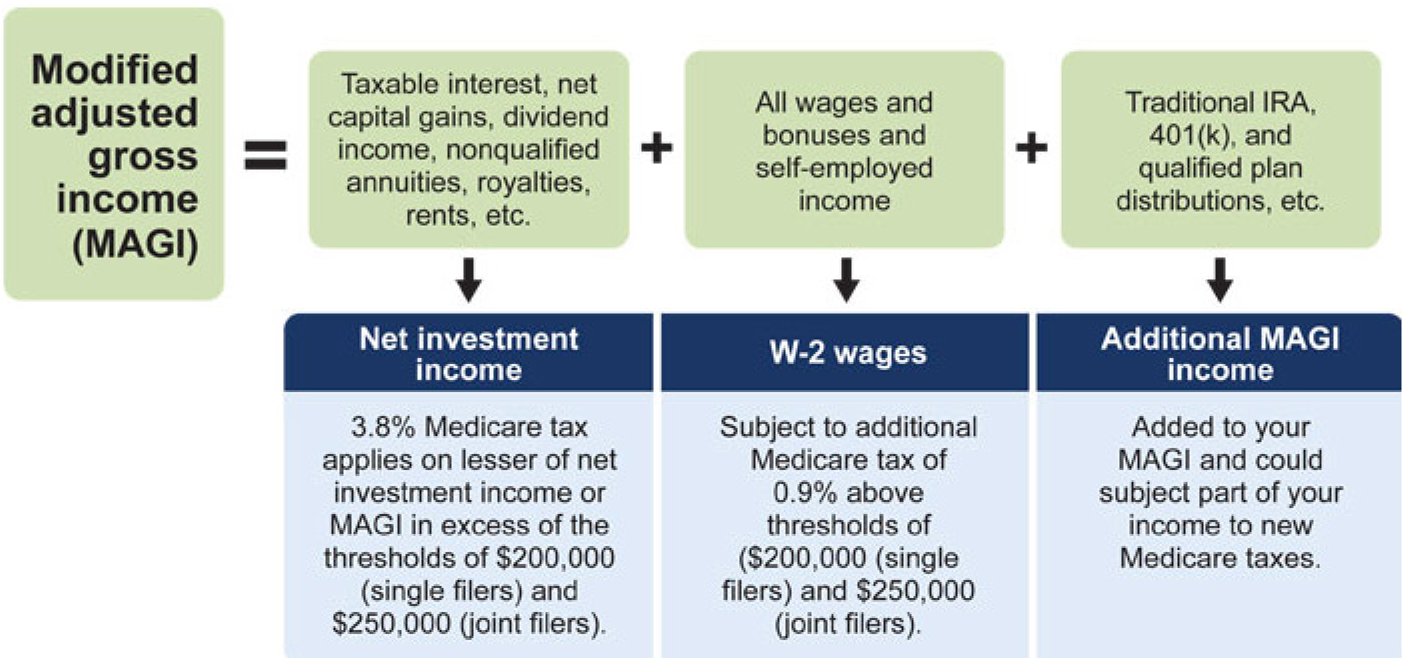
In other words, you'll owe the 3.8% tax on the amount by which your investment income exceeds the income thresholds, or, if your wages alone already are higher than the income thresholds, you'll owe tax on the lesser of net investment income or MAGI that exceeds the thresholds.

The chart below summarizes the changes. Picture three buckets: one for net investment income, one for compensation (like W-2 wages), and one for additional taxable income. Add the buckets together and they equal adjusted gross income. Add foreign earned income and it equals modified adjusted gross income. There are two types of additional Medicare tax: 3.8% on the lesser of net investment income or MAGI above the thresholds, and a 0.9% surcharge tax on MAGI above the thresholds.

How the new health care tax works



Three hypothetical examples

Adam's MAGI is $240,000, of which $180,000 is wages and $60,000 net investment income. His MAGI is $40,000 over the $200,000 threshold for individuals. He'll owe the 3.8% Medicare tax on his $40,000 over the threshold, because it is less than his $60,000 in net investment income. Remember, the law states that the Medicare tax is based on the lesser of MAGI over the thresholds or net investment income. Adam's Medicare surtax will be $1,520 (3.8% of $40,000). He won't owe a 0.9% Medicare surtax on wages—his are below the $200,000 earned income threshold for individuals.

Joan's MAGI is $230,000, of which $220,000 is wages and $10,000 net investment income. Her MAGI is $30,000 over the $200,000 threshold for individuals. She'll owe the 3.8% Medicare tax on her $10,000 of net investment income, because it is less than the amount she is over the MAGI threshold ($30,000). Joan will also owe 0.9% on the $20,000 she is over the $200,000 earned income threshold for individuals. So Joan's Medicare surtax will be $560, which includes $380 (3.8% of $10,000) and $180 (0.9% of $20,000).

Paul and Ann's MAGI is $372,000, of which $330,000 is wages and $42,000 net investment income. Their MAGI is $122,000 over the $250,000 threshold for married couples filing jointly. They'll owe the 3.8% on their $42,000 of net investment income, because it is less than the amount they are over the MAGI threshold ($122,000). They'll also owe 0.9% on the $80,000 that their wages are over the $250,000 earned income threshold for married couples filing jointly. Their total Medicare tax surcharge will be $2,316, which includes $1,596 (3.8% of $42,000) and $720 (0.9% on $80,000).

What's investment income and what's not

For tax planning purposes, it's important to know that "unearned" net investment income includes net rental income, dividends, taxable interest, net capital gains from the sale of investments (including second homes and rental properties), royalties, passive income from investments in which you do not actively participate (such as a partnership), and the taxable portion of nonqualified annuity payments.

Net investment income does not include tax-exempt interest from municipal bonds (or funds); withdrawals from a retirement plan such as a traditional IRA, Roth IRA, or 401(k); and payouts from traditional defined-benefit pension plans or annuities that are part of retirement plans. Also exempt are life-insurance proceeds, veterans' benefits, Social Security benefits, and income from businesses in which you actively participate, such as S corporations or partnerships.

Reminder about withdrawals from retirement accounts

If you've reached age 70½ and have begun taking minimum required distributions from a traditional IRA, 401(k), or 403(b), be aware that these withdrawals are included in MAGI and count toward the surtax's income thresholds. When added to net investment income and any wages, they could push you over the thresholds and subject you to the new tax. Qualified withdrawals from a Roth IRA or Roth 401(k), however, are not included in MAGI and net investment income calculations.

What you can do

Be prepared. If you're married, filing jointly, and your combined earned income will exceed the $250,000 income threshold for couples, you'll want to make sure that your joint Medicare surtax for the year isn't significantly higher than you anticipated.

Your employer won't take your spouse's income into consideration when figuring your Medicare tax withholding, but you can use IRS Form W-4 to have an additional amount deducted from your pay to cover the extra 0.9% tax on the amount by which you and your spouse exceed the combined income threshold.

Reducing MAGI is difficult for those who are still working. One strategy would be to maximize your contributions to pretax retirement plans like 401(k)s or 403(b)s.

Also as previously mentioned, qualified withdrawals from a Roth IRA or 401(k) are not included in your MAGI.[1] If you expect to be close to the MAGI threshold when you begin taking minimum required distributions, you might consider the effect future taxable distributions will have on your exposure to the tax.

The more complex planning challenges come into play with the net investment income portion of the new tax. But with help from a financial adviser and careful execution of a well-designed plan, there may be ways you can potentially reduce net investment income and, thus, the potential impact of this new tax.

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One possible strategy would be to shift some of your investments with taxable earnings into municipal bonds and municipal bond funds, whose earnings are excluded from the MAGI and the net investment income calculation. They also provide a double potential benefit of not triggering the surtax on other investment income and are also excluded from the Medicare surtax. Additionally, investments that produce taxable interest or that pay dividends could be held in a tax-deferred account like an IRA or possibly a tax-deferred annuity.

You may also consider owning a form of permanent life insurance, as the cash value of these polices when withdrawn is not considered net investment income.

All in all, a tax-smart investment plan is more important than ever. Talk to your tax adviser to ensure your tax planning matches your investment and income needs.

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1. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, die, suffer a disability, or make a qualified first-time home purchase.

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