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Medicare Tax Increases Beginning in 2013

The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA) provide for increases in Medicare taxes beginning in 2013 and, for the first time, subjects non-wage income to Medicare tax.

Wages and Self-Employment Income

The PPACA imposes an additional .09% Medicare tax on wages and self-employment income for tax years beginning after December 31, 2012. The additional tax applies to individuals with compensation in excess of certain threshold amounts ($200,000 for single taxpayers, $250,000 for married taxpayers filing a joint return, and $125,000 for married couples filing separate returns). The new Medicare tax rate on wages and self-employment income in excess of the threshold amounts will be 2.35% for employees and 3.8% for self-employed individuals.

Unearned Income

The HCERA imposes a Medicare tax of 3.8% on investment income for tax years beginning after December 31, 2012. The additional tax applies to individuals, estates and trusts on the lesser of net investment income or modified adjusted gross income for individuals and adjusted income for estates and trusts in excess of certain threshold amounts ($200,000 for single taxpayers, $250,000 for married taxpayers filing a joint return, $125,000 for married couples filing separate returns, and generally $11,650, based on the 2012 tax brackets, for estates and trusts).

Generally, net investment income includes the sum of:

- Gross amounts of interest, dividends, annuities, royalties and rents unless such income is derived in the ordinary course of a trade or business; plus
- Gross income derived from the trade or business of a passive activity (e.g., through ownership in a partnership, limited liability company (LLC), or S corporation); plus
- Net gain attributable to the sale of property not held in a trade or business (e.g., capital gains from the sale of investment securities); less
- Deductions properly allocable to such gross income or net gain.

Generally, a passive activity means any activity that involves the conduct of any trade or business in which a taxpayer does not materially participate. The ownership of a limited partnership interest, LLC membership interest or shares of an S corporation in which the owner does not materially participate in the respective entity will be treated as the ownership of a passive activity.

Many taxpayers will be impacted by the new Medicare tax that will apply to dividends, interest, capital gains, and the flow-through income from business entities in which the taxpayers do not actively participate.

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The determination of whether an activity is passive is determined with respect to each individual taxpayer. Therefore, members of an LLC, partners in a partnership, and shareholders of an S corporation may be treated differently depending on whether the members, partners, or shareholders materially participate in the activities of the respective entity. The disparate treatment of members of pass-through entities may impact operating, partnership, and shareholder agreements that provide for cash distributions to members, partners, and shareholders to pay individual tax liabilities.

There are some complex rules relating to the measurement of material participation. The participation of a spouse will be taken into account in determining the material participation of a taxpayer. Special rules can apply to individuals in the real property business.

The test of material participation for trusts is generally determined by measuring the material participation of the trustee of the trust. However, an exception exists for grantor trusts. The test is measured by the material participation of the person who is deemed to be the owner of the trust.

The Medicare tax may also affect active owners to the extent of net investment income of a sole proprietorship or pass-through entity generated from an investment in working capital. Generally, interest, dividend and royalty income generated in the normal course of a trade or business would not be subject to tax. Net investment income from “idle” cash (amounts set aside for the needs of the business) will be subject to the Medicare tax.

Upon the disposition of an interest in a pass-through entity, only the portion of the gain attributable to non-active assets of the entity (the passive activity within the entity) will be subject to the Medicare tax.

The IRS has not issued formal guidance in connection with Medicare tax. In April 2012, the IRS indicated that proposed regulations would be released soon. There is no guidance on how losses from a passive activity should be handled.

In addition to the Medicare tax on unearned income, there is the prospect that tax rates, in general, will increase in 2013 with the expiration of the “Bush tax cuts,” particularly, with respect to dividends and capital gains.

There are a variety of planning ideas that should be considered, such as:

- Convert taxable investments to tax exempt or tax deferred investments (e.g., municipal bonds, tax-deferred annuities, certain life insurance products)
- Accelerate security sales in 2012
- Change the timing of other investment income before 2013 (e.g., sell bonds close to maturity)
- Reduce non-investment income so that more of the threshold amounts protect investment income
    - Convert IRAs to Roth IRAs to avoid minimum distribution requirements
    - Defer compensation
- Move investments to charitable trusts
- Change status with respect to material participation in any passive activity

In connection with the last planning idea, changing the status of participation in the activity of an LLC or partnership to material participation may have adverse implications with respect to self-employment tax liabilities. Making a similar change as an S corporation shareholder may necessitate the payment of some taxable compensation that would be subject to employment taxes. Any proposed change in activity status that would alter the economic arrangements among the owners of the respective entities would have to be evaluated.

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Please contact your Butzel Long attorney to assist you in evaluating the impact of the Medicare tax changes and the potential expiration of the "Bush tax cuts" and to suggest tax planning ideas specific to your situation.

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