RAYMOND JAMES

Planning for Medicare taxes

Understand what these additional taxes are, when they are applied and how best to mitigate their impact

Many people are familiar with the regular Medicare payroll tax. However, it may come as a surprise that there are two additional types of taxes that you should be aware of. While these two types of additional Medicare taxes are not well-known, they have actually been in effect since January 1, 2013. The primary impact of these taxes is felt by those at the higher income levels.

These two relatively unknown Medicare taxes are:

Additional Medicare Tax
0.9% additional Medicare payroll tax is applied to compensation, such as wages and self-employed income, if it exceeds the statutory threshold amount, based on filing status, shown below.

Net Investment Income Tax
3.8% Medicare surtax is levied on the lesser of the net investment income or the amount by which their modified adjusted gross income (MAGI) exceeds the statutory threshold amount, based on filing status, shown below.

Threshold amounts

Married filing jointly: **$250,000**	Married filing separately: **$125,000**	Single or head of household: **$200,000**

Not indexed for inflation. As of 1/1/2018.

ADDITIONAL MEDICARE TAX

In addition to the standard 1.45% Medicare payroll tax applied to all wage earners, an additional 0.9% Medicare payroll tax is applied to earnings of high-wage earners with income above the threshold amounts listed above.

KEY TAKEAWAYS

Earning more than $250,000 when married filing jointly, or $200,000 when filing single or as a head of household, means you'll likely be impacted by the 0.9% additional payroll tax on compensation.

There may be ways to potentially reduce your net investment income – and the potential impact of this particular tax.

Talk to your financial advisor and tax advisor to address your circumstances and develop a tax-smart financial plan.

An Example

- Married couple filing jointly
- $280,000 total earnings
- Standard Medicare tax of 1.45% (up to the $250,000 limit)
- 2.35% (1.45% and 0.9%), for the $30,000 of additional earnings exceeding the $250,000 threshold amount

What employees should know about additional Medicare tax

The additional 0.9% Medicare payroll tax includes sources of income associated with:

- Wages
- Compensation
- Self-employed income
- Noncash compensation
- Reported tips
  - Employees may give their employers money to pay the rest of the taxes if they don't receive enough wages for their employer to withhold all the taxes owed.
- Nonqualified deferred compensation (NQDC)
  - The special timing rule for the regular Medicare tax also applies to withholding for the additional Medicare tax. In general, employers should withhold Medicare taxes as soon as the deferred compensation is "reasonably ascertainable."

Employers will automatically begin withholding the additional tax with the first pay period in which an employee's wages exceed $200,000. While employees cannot request additional withholding specifically for the additional Medicare tax, they can request additional income tax withholding on Form W-4. Those with too little tax withheld or who did not pay enough estimated tax may owe an estimated tax penalty that can be reported on Form 8959 with their tax return.

NET INVESTMENT INCOME TAX

In addition to the 0.9% Medicare payroll tax associated with earned income, you could also be subject to a 3.8% Medicare surtax associated with unearned income. Specifically, unearned income classified as net investment income (NII). This tax is applied on the lesser of an individual's net investment income (NII) or the amount by which their modified adjusted gross income (MAGI) exceeds the threshold amount.

DOES NET INVESTMENT INCOME APPLY TO YOU?

You can determine so by calculating your MAGI. This is done by taking your adjusted gross income (AGI) and adding back certain deductions. "Add back" items include:

- Half of self-employment tax
  - Self-employed individuals are required to pay "payroll" taxes that an employer would otherwise take; these extra taxes can be deducted from AGI, but are included in MAGI.
- Student loan interest
- Tuition and fees deduction
- Qualified tuition expenses
- Passive income or loss
- Rental losses
- IRA contributions and taxable Social Security payments
- Exclusion for income from U.S. savings bonds
- Exclusion for adoption expenses

In order to evaluate net investment income tax (NIIT) exposure, it's important to know what is, or is not, classified as NII.

It includes:

- Net rental income
- Dividends
- Taxable interest
- Net capital gains from the sale of investments (including second homes and rental properties)
- Royalty income (rights in mineral, oil, gas, etc.)
- Passive income from investments you don't actively participate in (such as a partnership)
- Taxable portion of nonqualified annuity payments

What it doesn't include:

- Wages
- Unemployment compensation
- Alimony
- Tax-exempt interest from municipal bonds (or funds)
- Withdrawals from a retirement plan such as a traditional IRA – distribution are taxable and therefore included in MAGI , Roth IRA or 401(k)
- Payouts from traditional defined benefit pension plans
- Annuities that are part of retirement plans
- Life insurance proceeds
- Veterans benefits
- Social Security benefits
- Income from businesses you actively participate in (such as S corporations or partnerships)
- Gain from the sale of a principal residence on portion excluded for income tax purposes

An Example

The taxpayer's MAGI exceeds the threshold of $200,000 for single taxpayers by $70,000. The taxpayer's NII is $90,000 associated with the passive partnership interest.

Given this scenario, the NIIT is based on the lesser of $70,000 (the amount that the taxpayer's MAGI exceeds the $200,000 threshold) or $90,000 (taxpayer's NII). The taxpayer owes NIIT of $2,660 ($70,000 x 3.8%).

Keep in mind that any form of income that increases your MAGI above the threshold could cause taxes to be owed on your NII. Those age 70 1/2 or older are subject to larger required minimum distributions (RMD) over time, and their MAGI can gradually increase as they get older. This increase in RMD payment may eventually cause their MAGI to rise to such a level that any NII above the threshold amount would now be subject to the 3.8% surtax. Because the threshold amounts are not adjusted for inflation, the impact of this gradual increase of income could have a significant impact.

ADDRESSING GAINS IN NET INVESTMENT INCOME (NII)

To the extent that gains are not otherwise offset by capital losses, the following gains are common examples of items included in computing NII:

- Gains from the sale of stocks, bonds and mutual funds.
- Capital gain distributions from mutual funds.
- Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence).
- Gains from the sale of interests in partnerships and S corporations (to the extent the partner or shareholder was a passive owner).

The tax doesn't include any gain on the sale of a principal residence excluded from gross income for regular income tax purposes (the first $250,000 for a single tax filer or $500,000 for a married couple).

Determining if net investment income tax (NIIT) applies example

SINGLE FILER

Deborah earns $45,000 in wages. She sells her principal residence that she has owned and resided in for the last 10 years for $1 million. The cost basis in the home is $600,000, so the realized gain on the sale is $400,000. Her recognized gain, subject to regular income taxes, is $150,000, due to the $250,000 exclusion on the realized gain associated with the sale of the principal residence. Her MAGI is $195,000, which includes her $45,000 in wages and $150,000 net gain from the sale of her house.

Since Deborah's MAGI is below the threshold amount of $200,000, she does not owe any 3.8% Medicare surtax on the net investment income.

MARRIED FILING JOINTLY

Alexandra and Charles make $75,000 in wages. They sell their principal residence that they have owned and resided in for the last 10 years for $1.3 million. The cost basis in the home is $700,000 so the realized gain on the sale is $600,000. Their recognized gain, subject to regular income taxes, is $100,000, due to the $500,000 exclusion on the realized gain associated with the sale of their principal residence. Their MAGI is $300,000, which includes their $75,000 in wages, $100,000 net gain from the sale of their house, and $125,000 from the sale of investments.

They're subject to NIIT on the lesser of:

$225,000
Total NII including $125,000 other NII and $100,000 recognized gain

$50,000
This is the amount their MAGI exceeds the $250,000 married filing jointly threshold

Alexandra and Charles' net investment income tax owed is $1,900 ($50,000 X 3.8%).

HOW TO REPORT NET INVESTMENT INCOME TAX (NIIT)

Determining what is considered NII can be tricky, so it is a good idea to check with a tax advisor about your situation. Here's a look at some of the specifics.

The tax applies at a rate of 3.8% to certain NII of individuals, estates and trusts that have income above the threshold amounts. Estates and trusts are subject to tax on NII if they have undistributed NII and adjusted gross income in excess of the highest tax bracket for estates and trusts. For 2018, that threshold amount is $12,500 or higher. Keep in mind that some trusts are not subject to the tax and may have unique rules, so ask your tax advisor for guidance in this situation. The tax will be reported on Form 1040 for individuals, and Form 1041 for estates and trusts.

Individuals, estates and trusts subject to the tax should adjust their income tax withholding or estimated payments to avoid underpayment penalties.

Applying additional Medicare taxes examples

SINGLE FILER

Associated Medicare taxes for a single tax filer

Joan's MAGI is $240,000, of which $220,000 is wages and $20,000 is NII. Her MAGI is $40,000 over the $200,000 threshold for individuals.

She'll owe:

$760
3.8% Medicare tax on her $20,000 of NII because it is less than the amount she is over the MAGI threshold ($40,000)

+

$180
0.9% on the $20,000 in wages in excess of the income threshold for individuals

Joan's additional Medicare tax will be $940.

MARRIED COUPLE FILING JOINTLY

Associated Medicare taxes on a married filing jointly tax filer

Paul and Anne's MAGI is $385,000, of which $320,000 is wages and $65,000 is NII. Their MAGI is $135,000 over the $250,000 threshold for married couples filing jointly.

They'll owe:

$2,470
3.8% Medicare tax on their $65,000 of NII because it is less than the amount they are over the MAGI threshold ($135,000)

+

$630
0.9% on the $70,000 they are over the $250,000 earned income threshold for married couples filing jointly

Paul and Anne's additional Medicare tax will be $3,100.

REDUCING THE IMPACT OF MEDICARE TAXES

Being prepared is the best way to get ahead of any additional taxes. Here are seven tips to help you:

1. **Use IRS Form W-4 to have an additional amount deducted from your pay** to help cover any additional taxes.
2. **Maximize your contributions to pretax retirement plans** like traditional 401(k)s or 403(b)s to help reduce your MAGI when you're still working.
3. **Consider the impact of future taxable distributions, such as required minimum distributions or timed sale of stock, bonds and real estate.** These future taxable events will increase your MAGI and NII as a consequence.
4. **Shift some of your investments with taxable earnings into municipal bonds and municipal bond funds.** These earnings are excluded from the MAGI and net investment income calculations. 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.
5. **Consider the use of qualified Roth IRA and Roth 401(k) or 403(b) account withdrawals** which are not included in MAGI, nor NII.
6. **Consider owning a form of permanent life insurance.** The cash value of these policies when withdrawn is not considered net investment income.
7. **Work with your financial advisor.** He or she has the tools, resources and expertise to help you understand if these tax-planning strategies may be right for you.

Please note that changes in tax laws or regulations may occur at any time and could substantially impact your unique situation. Raymond James financial advisors do not render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.

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