

Understanding the New Medicare Tax on Unearned Income

Health-care reform legislation enacted in 2010 included a new 3.8% Medicare tax on the unearned income of certain high-income individuals. The new tax, known as the unearned income Medicare contribution tax, or the net investment income tax (NIIT), took effect on January 1, 2013.

Who must pay the new tax?

The NIIT applies to individuals who have “net investment income,” and who have modified adjusted gross income (MAGI) that exceeds certain levels (see the chart below). (Estates and trusts are also subject to the new law, although slightly different rules apply). In general, nonresident aliens are not subject to the new tax.

Filing Status	MAGI over...
Single/Head of household	\$200,000
Married filing jointly or Qualifying widow(er)	\$250,000
Married filing separately	\$125,000

What is MAGI?

For most taxpayers, MAGI is simply adjusted gross income (AGI), increased by the amount of any foreign earned income exclusion.

AGI is your gross income (e.g., wages, salaries, tips, interest, dividends, business income or loss, capital gains or losses, IRA and retirement plan distributions, rental and royalty income, farm income and loss, unemployment compensation, alimony, taxable Social Security benefits), reduced by certain “above-the-line” deductions (see page one of IRS Form 1040 for a complete list of adjustments).

Note that AGI (and therefore MAGI) is determined before taking into account any standard or itemized deductions or personal exemptions. Note also that deductible contributions to IRAs and pretax contributions to employer retirement plans will lower your MAGI.

What is investment income?

In general, investment income includes interest, dividends, rental and royalty income, taxable nonqualified annuity income, certain passive business income, and capital gains—for example, gains (to the extent not otherwise offset by losses) from the sale of stocks, bonds, and mutual funds; capital gains distributions from mutual funds; gains from the sale of interests in partnerships and S corporations (to the extent you were a passive owner), and gains from the sale of investment real estate (including gains from the sale of a second home that’s not a primary residence).

Gains from the sale of a primary residence may also be subject to the tax, but only to the extent the gain exceeds the amount you can exclude from gross income for regular income tax purposes. For example, the first \$250,000 (\$500,000 in the case of a married couple) of gain recognized on the sale of a principal residence is generally excluded for regular income tax purposes, and is therefore also excluded from the NIIT.

Investment income does not include wages, unemployment compensation, operating income from a nonpassive business, interest on tax exempt bonds, veterans benefits, or distributions from IRAs and most retirement plans (e.g., 401(k)s, profit-sharing plans, defined benefit plans, ESOPs, 403(b) plans, SIMPLE plans, SEPs, and 457(b) plans).

Net investment income is your investment income reduced by certain expenses properly allocable to the income—for example, investment advisory and brokerage fees, investment interest expenses, expenses related to rental and royalty income, and state and local income taxes.

How is the tax calculated?

The tax is equal to 3.8% of the lesser of (a) your net investment income, or (b) your MAGI in excess of the statutory dollar amount that applies to you based on your

tax filing status. So, effectively, you’ll be subject to the additional 3.8% tax only if your MAGI exceeds the dollar thresholds listed in the chart above.

Example: Sybil, who is single, has wages of \$180,000 and \$15,000 of dividends and capital gains. Sybil’s MAGI is \$195,000, which is less than the \$200,000 statutory threshold. Sybil is not subject to the NIIT.

Example: Mary and Matthew have \$180,000 of wages. They also received \$90,000 from a passive partnership interest, which is considered net investment income. Their MAGI is \$270,000, which exceeds the threshold for married taxpayers filing jointly by \$20,000. The NIIT is based on the lesser of \$20,000 (the amount by which their MAGI exceeds the \$250,000 threshold) or \$90,000 (their net investment income). Mary and Matthew owe NIIT of \$760 (\$20,000 x 3.8%).

Note: The NIIT is subject to the estimated tax rules. You may need to adjust your income tax withholding or estimated payments to avoid underpayment penalties.



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