

New Medicare Tax on "Unearned" Net Investment Income

(February 16, 2012)

Q-1: Is there a 3.8% real estate "sales tax" or a transfer tax created in health care bill?

No. There is neither a real estate "sales tax" nor a real estate transfer tax under any federal law. The Internet has generated several viral items describing such a tax. Those Internet postings are totally false. The 2010 health care legislation did create a new 3.8% tax, but it applies only to a limited group of taxpayers.

Q-2: So who will be subject to the new tax? When is it effective?

The new 3.8% tax will apply to the "unearned" income of "High Income" taxpayers. The new Medicare tax on unearned income will take effect January 1, 2013. Proceeds from the tax will be allocated to shoring up the Medicare fund.

Q-3: Who is a "High Income" Taxpayer?

Those whose tax filing status is "single" will be subject to the new unearned income taxes if they have Adjusted Gross Income (AGI) of more than \$200,000. Married couples filing a joint return with AGI of more than \$250,000 will also be subject to the new tax. (The AGI threshold for married filing separate returns is \$125,000.)

Q-4: Are the \$200,000 and \$250,000 thresholds indexed for inflation?

No. Thus, over time, more individuals may become subject to this tax.

Q-5: What is "unearned" net investment income?

Unearned income is the income that an individual derives from investing his/her capital. It includes capital gains, rents, dividends and interest income. It also comes from some investments in active businesses if the investor is not an active participant in the business. The portion of unearned income that is subject both to income tax and the new Medicare tax is the amount of income derived from these sources, reduced by any expenses associated with earning that income. (Hence the term "net" investment income.)

Q-6: So the new tax will apply to rents from investment properties that I own?

Maybe. Remember that net investment income includes only net rental income. Thus, gross rents would not be subject to the tax. Rather, gross rents would be reduced (as they are under the income tax) by all allowable expenses, including depreciation, cost of repairs, property taxes and interest expense associated with debt service. AGI includes net income from rent, so if your AGI is above the \$200,000/\$250,000 thresholds, then the rental income might be subject to the tax.

For many investment real estate owners, the net rents will be the same as or similar to the amounts reported on their Schedule E, filed with their Form 1040 Income Tax Return. (For calculations, see Q-7, below. See also Q-8 through Q-12 related to capital gain from sale of principal residence, losses on sale and to vacation homes, below.)

Q-7: Does the tax apply to the yearly appreciation of an asset?

No. Capital gains are subject to this new tax only in the year when the asset is sold. The amount of the gain will be measured in the same way that it is for income tax purposes. This rule applies to real estate and all

other appreciating capital assets (including stocks and bonds). Net capital gains are taxable only in the year of sale.

Q-8: How is the new 3.8% Medicare tax calculated?

The new 3.8% Medicare tax is assessed only when Adjusted Gross Income (AGI) is more than \$200,000/\$250,000. (See Q-2 above.) AGI includes net income from interest, dividends, rents and capital gains, as well as earned compensation and several additional forms of income presented on a Form 1040 Income Tax Return.

The tax is NOT imposed on the total AGI, nor is it imposed solely on the investment income. Rather, the taxable amount will depend on the operation of a formula. The taxpayer will determine the LESSER of (1) net investment income OR (2) the excess of AGI over the \$200,000/\$250,000 AGI thresholds. Thus, if net investment income is the smaller amount, then the 3.8% tax is applied only to the net investment income amount. If the excess over the thresholds is the smaller amount, then the 3.8% tax would apply only to the excess amount.

Q-9: Give me an example.

If AGI for a single individual is \$275,000, then the excess over \$200,000 would be \$75,000 (\$275,000 minus \$200,000). Assume that this individual's net investment income is \$60,000. The new 3.8% tax applies to the smaller amount. In this example, \$60,000 of net investment income is less than the \$75,000 excess over the threshold. Thus, in this example, the 3.8% tax is applied to the \$60,000.

If this single individual had AGI if \$275,000 and net investment income of \$90,000, then the new tax would be imposed on the smaller amount: the \$75,000 of excess over \$200,000.

Rules of thumb for predicting the application of this tax year to year are not readily determinable, largely because the proportion of net investment income compared to AGI will vary from year to year and from individual to individual.

Q-10: Will the \$250,000/\$500,000 exclusion on the sale of a principal residence continue to apply?

Yes. Any gain from the sale of a principal residence that is less than \$250,000 (individual) or \$500,000 (joint return) will continue to be excluded from the income tax. The 3.8% tax will NOT apply to this excluded amount of the gain.

Q-11: Will the 3.8% tax apply to any part of the gain on the sale of a principal residence?

Maybe. The new Medicare tax would apply only to any gain realized that is more than the \$250K/\$500K existing primary home exclusion (known as the "taxable gain"), and only if the seller has AGI above the \$200K/\$250K AGI thresholds.

So, for example, if the taxable gain was \$30,000 and a married couple had AGI (which would include the taxable gain) of \$180,000, the 3.8% tax would not apply because AGI is less than \$250,000. If that same couple had AGI of \$290,000, then the application of the 3.8% tax would be subject to the same formula described above. The \$30,000 taxable gain on the sale would be less than the \$40,000 excess above \$250,000 AGI, so the \$30,000 gain would be subject to the new 3.8% tax.

Q-12: Is rent from a vacation home subject to the 3.8% tax? And what about the gain on sale of a vacation or rental property?

The application of the tax will depend on whether the vacation home has been rented out, the period for which it has been rented and whether the property is solely for the enjoyment of the owner. If the owner

has rented the home out to others, then the 14-day rent exclusion will continue to apply. Thus, if the owner rents the property to others (including family members) for 14 or fewer days, there would be no net investment tax. (Note that no deductions for expenses would be available, as under current law.)

If the home has been rented to others (including family members) for more than 14 days, then the rents (minus related expenses) would be considered as part of net investment income and could, depending on AGI and the calculations described above, be subject to the new tax.

If the vacation home has been used solely for personal enjoyment (i.e., there is no rental income and no associated expenses), then a gain on sale would be treated as net investment income and could be subject to the tax, depending on AGI. Similarly, if the property had generated rents, any net gain on sale could also be included in net investment income. The amount of the tax (if any) would depend on the calculation formula, above in Q-8 and Q-9.

Q-13: My rental property generates a net loss each year. How will those losses be factored into the new tax? And what if I have net capital losses when I sell?

Net losses from rents and net capital losses reduce AGI. Thus, the losses themselves would not be subject to the tax. If, after losses, AGI still exceeds the High Income thresholds, the 3.8% tax would still apply to any net rental, interest or dividends income

Q-14: I earn all of my income from real estate investments that I own and operate myself. Will my rents and gains be subject to the new tax?

No. If the ownership and operation of real estate you own is your sole occupation, then those activities are what's called your "trade or business." Income derived from a trade or business is not subject to the new 3.8% tax. If the owner of rental properties has a "day job," however, real estate investments are not considered as a trade or business, but are rather considered as investments, even if they are a major source of income.

Many Realtors engage in business activities that are the "typical" selling, leasing and brokerage endeavors usually associated with the term "Realtor." If they also own rental real estate assets as part of their own personal investment portfolio, the net rents from that portfolio could become subject to the new 3.8% tax on net investment income, depending on AGI.

Q-15: Will "High Income Filers" lose any portion of the Mortgage Interest Deduction?

No. The mortgage interest deduction is unchanged. No cap was imposed on any itemized deductions.

Q-16: Why is this new tax called a "Medicare tax?"

The revenues generated from this tax will be allocated to the Medicare Trust Fund that is part of the Social Security System. That fund is currently on shaky financial footing. These additional revenues are intended to shore up the Medicare Trust Fund.

Q-17: How will this new tax affect marginal (the highest) tax rates when it is combined with existing law and with the possible expiration of the Bush tax cuts enacted in 2001?

Marginal tax rates are the tax rates assessed on the "last" dollars included in taxable income. If the Bush tax cuts are allowed to expire, then the marginal rates for upper income individuals will increase, particularly for capital gains income. The chart below reflects the impact of those changes, presented based on implementation of current law effective dates.

MAXIMUM MARGINAL TAX RATES – 2010 – 2013*
(Marginal Tax Bracket is Rate Imposed on Last Dollar of Income)

Year Income Category	Maximum Marginal Rate without Medicare	Maximum Rate with Medicare (Employee Only – 1.45%)	Maximum Rate with Medicare (Self-employed – 2.9%)
2010 (Current Law)			
Ordinary Income	35%	36.45%	37.9%
Capital Gains, Dividends	15%	15%	15%
Rental Income, Interest	35%	35%	35%
2011 (Expiration of Bush Tax Cuts)			
Ordinary Income	39.6%	41.05%	42.5%
Capital Gains	20%	20%	20%
Dividends, Interest	39.6%	39.6%	39.6%
Rental Income	39.6%	39.6%	39.6%
2013 (Adds new Medicare Taxes)			
Ordinary Income (Adds 0.9% tax on Earned Income)	39.6%	41.95%	43.4%
Capital Gains (Adds 3.8% tax on Unearned Income)	20%	23.8%	23.8%
Dividends, Interest (Adds 3.8% tax on Unearned Income)	39.6%	43.4%	43.4%
Rental Income (Adds 3.8% tax on Unearned Income)	39.6%	43.4%	43.4%

*Several special calculations actually increase the marginal tax rates of many upper income individuals. These include the loss of the personal exemption, loss of some itemized deductions and special self-employment tax deductions and rate adjustments. This chart does not reflect those special calculations because their impact will vary from taxpayer to taxpayer.