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Health-Care Reform: High-Income Individuals Face New Medicare-Related Taxes in 2013

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The health-care reform legislation enacted in 2010 included new Medicare-related taxes. These new taxes take effect in 2013, and target high-income individuals and families. While additional details and clarifications will become available between now and 2013, here's what you need to know.

New additional Medicare payroll tax

If you receive a paycheck, you probably have some familiarity with the Federal Insurance Contributions Act (FICA) employment tax; at the very least, you've probably seen the tax deducted on your paystub. The old age, survivors, and disability insurance ("OASDI") portion of this FICA tax is equal to 6.2 percent (4.2 percent for employees in 2011 and 2012) of covered wages (up to $110,100 in 2012). The hospital insurance or HI portion of the tax (commonly referred to as the Medicare payroll tax) is equal to 1.45 percent of covered wages, and is not subject to a wage cap. FICA tax is assessed on both employers and employees (that is, an employer is subject to the 6.2 percent OASDI tax and the 1.45 percent HI tax, and each employee is subject to the 6.2 percent (4.2 percent in 2011 and 2012) OASDI tax and the 1.45 percent HI tax on wages as well), with employers responsible for collecting and remitting the employees' portions of the tax.

Self-employed individuals are responsible for paying an amount equivalent to the combined employer and employee rates on net self-employment income (12.4 percent (10.4 percent in 2011 and 2012) OASDI tax on net self-employment income up to the taxable wage base, and 2.9 percent HI tax on all net self-employment income), but are able to take a deduction for the employer portion of the self-employment taxes paid.

Beginning in 2013, the health-care reform legislation increases the hospital insurance (HI) tax on high-wage individuals by 0.9 percent (to 2.35 percent). Who will be subject to the additional tax? If you're married and file a joint federal income tax return, the additional HI tax will apply to the extent that the combined wages of you and your spouse exceed $250,000. If you're married but file a separate return, the additional tax will apply to wages that exceed $125,000. For everyone else, the threshold is $200,000 of wages. So, in 2013, a single individual with wages of $230,000 will owe HI tax at a rate of 1.45 percent on the first $200,000 of wages, and HI tax at a rate of 2.35 percent on the remaining $30,000 of wages for the year.

Employers will be responsible for collecting and remitting the additional tax on wages that exceed $200,000. (Employers will not factor in the wages of a married employee's spouse.) You'll be responsible for the additional tax if the amount withheld from your wages is insufficient. The employer portion of the HI tax remains unchanged (at 1.45 percent).

If you're self-employed, the additional 0.9 percent tax applies to self-employment income that exceeds the dollar amounts above (reduced, though, by any wages subject to FICA tax). If you're self-employed, you won't be able to deduct any portion of the additional tax.

New Medicare contribution tax on unearned income

Beginning in 2013, a new 3.8 percent Medicare contribution tax will be imposed on the unearned income of high-income individuals (the new tax is also imposed on estates and trusts, although slightly different rules apply). The tax is equal to 3.8 percent of the lesser of your net investment income (generally, net income from interest, dividends, annuities, royalties and rents, and capital gains, as well as income from a business that is considered a passive activity or a business that trades financial instruments or commodities), or your modified adjusted gross income (basically, your adjusted gross income increased by any foreign earned income exclusion) that exceeds $200,000 ($250,000 if married filing a joint federal income tax return, $125,000 if married filing a separate return).

So, effectively, you'll only be subject to the additional 3.8 percent tax if your adjusted gross income exceeds the dollar thresholds listed above. It's worth noting that interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence that are excluded from gross income are not considered net investment income for purposes of the additional tax. Qualified retirement plan and IRA distributions are also not considered investment income.

Together, these two new Medicare-related taxes are expected to provide a major source of revenue to finance other parts of health-care reform. The Joint Committee on Taxation projects that the combined revenue attributable to these two new taxes will exceed $210 billion over the ten-year period ending in 2019 (Source: Joint Committee on Taxation, Publication JCX-17-10, March 20, 2010).

Janney Montgomery Scott LLC Financial Advisors are available to discuss the suitability and risks involved with various products and strategies presented. We will be happy to provide a prospectus, when available, and other information upon request. Please note that the information provided includes reference to concepts that have legal, accounting and tax implications. It is not to be construed as legal, accounting or tax advice, and is provided as general information to you to assist in understanding the issues discussed. Neither Janney Montgomery Scott LLC nor its Financial Advisors (in their capacity as Financial Advisors) give tax, legal, or accounting advice. We would urge you to consult with your own attorney and/or accountant regarding the application of the information contained in this letter to the facts and circumstances of your particular situation.

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