

Proposed rules address increased Medicare and investment taxes on high-income individuals

The Patient Protection and Affordable Care Act (ACA) imposes an additional employee Medicare contribution and a new investment tax on high-income individuals for tax years beginning after December 31, 2012. Employers are responsible for withholding the additional Medicare tax on compensation paid to an employee in excess of \$200,000 in a calendar year, but have no such responsibility for the new investment tax. Recent proposed regulations provide guidance on Medicare tax withholding responsibilities and on defining “income” for purposes of the investment tax.

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Background

The ACA, adding section 3102(f) to the Internal Revenue Code (Code), imposes an additional .9 percent employee Medicare contribution (known as the Additional Medicare Tax) on wages, other compensation, or self-employment income in excess of \$250,000 for joint returns, \$125,000 for married individuals who file separately, and \$200,000 for all others. This increase, which went into effect on January 1, 2013, applies only to the employee's share of Federal Insurance Contributions Act (FICA); there is no employer match. For taxable years beginning after December 31, 2012, employers are required to withhold this additional tax on wages or compensation paid to an employee in excess of \$200,000.

The ACA, adding section 1411 to the Code, also imposes a 3.8 percent tax (known as the Additional Investment Tax) on investment income above specified thresholds for high-income individuals. This is not a payroll tax. It is paid by the individual on his or her tax return, but affected employees may choose to increase wage-based income tax withholding to avoid separate estimated tax filings. The tax applies to the lesser of (1) modified adjusted gross income (MAGI) over a threshold amount or (2) the sum of investment income. The threshold varies based on tax filing status: MAGI above \$200,000 for individuals, \$250,000 for couples filing jointly, and \$125,000 for spouses filing separately.

Proposed regulations – additional Medicare tax

The IRS issued [proposed regulations](#) and [Frequently Asked Questions](#) (FAQs) providing employers and payroll service providers with information on their withholding responsibilities for the Additional Medicare Tax. The proposed regulations provide rules for withholding, computing, reporting, and paying the Additional Medicare Tax on wages, self-employment income, and Railroad Retirement Tax Act (RRTA) compensation. They generally address which wages and employees are subject to this additional tax and when withholding begins.

Wages above \$200,000

An employee's compensation and wages in excess of \$200,000 that would normally be subject to the current FICA tax are subject to this Additional Medicare Tax. The regulations make clear that employers consider only the compensation paid to an individual employee. An employer should not take into account an employee's filing status or spousal income. Amounts deferred under a nonqualified deferred compensation plan will be taken into account using the usual special timing, early inclusion, and resolution date rules that apply to such plans for FICA purposes. The proposed regulations clarify that compensation and wages paid to employees who are nonresident aliens or US Citizens living abroad (e.g., expatriates) are subject to the Additional Medicare Tax as well.

Buck Comment. With this additional .9 percent tax (as well as the 3.8 percent investment tax, discussed below), an employee may have a compelling interest in controlling the timing of the inclusion of nonqualified accruals in order to minimize any additional amounts owed.

When to withhold

An employer must begin to withhold the Additional Medicare Tax when wages paid to an employee exceed \$200,000 in a calendar year, regardless of the employee's filing status and ultimate tax liability. An employer is required to withhold the additional tax even when an employee ultimately might not be required to pay the tax because combined wages with the employee's spouse (e.g., filing a joint return) do not exceed \$250,000. (As explained below, an employee can recoup these amounts on his or her tax return.) The regulations provide that amounts in a calendar year must be withheld in the pay period in which an employee's wages are first in excess of the \$200,000 threshold.

Penalties for failing to withhold

The proposed regulations provide that employers may not withhold the Additional Medicare Tax on wages of \$200,000 or less, even if requested by the employee. However, the employee can increase income tax withholding on the Form W-4 with the employer to accommodate any Additional Medicare Tax liability the employee might have from a joint tax return or other outside compensation. The employer will be liable for the Additional Medicare Tax withholding unless it is otherwise paid by the employee. Nevertheless, an employer that fails to withhold, deposit, or report the tax can be subject to penalties for such failure, even if the employee pays the tax.

Employee responsibilities

An employee is responsible for paying the tax on any amounts not previously paid through withholding or estimated tax. For example, in the instance where an employee's wages are not more than \$200,000, but the employee's joint tax return reports wages in excess of \$250,000, the employee is required to pay the Additional Medicare Tax. In addition, where the Additional Medicare Tax has been withheld by the employer, but is not owed (e.g., where a joint tax return reports wages of \$250,000 or less), the employee is entitled to a credit against his or her total tax liability on the Form 1040 for the year in which the tax was withheld.

Effective date

The IRS intends to finalize these proposed regulations sometime in 2013. With the withholding obligation beginning in 2013, the IRS has indicated that employers can rely on these proposed regulations until they are finalized. Any changes in the requirements provided in final regulations will apply prospectively to further periods. The IRS has asked for comments on the clarity of these proposed rules and how they can be made easier to understand. Comments are due by March 5, 2013.

Proposed regulations – additional investment tax

The IRS has also issued [proposed regulations](#) and [FAQs](#) on the Additional Investment Tax, which is a tax on certain investment income and generally does not create any reporting or withholding obligations for employers. Indeed, the IRS FAQs state that wage withholding of the tax is not required. Although the tax applies to individuals, not corporations, employers may want to understand how the new tax may affect employee decisions about benefit plans.

Buck Comment: Employees whose compensation income is approaching the MAGI income threshold may prefer making retirement plan contributions on a before-tax rather than on a Roth basis, because before-tax deferrals aren't included in MAGI. Conversely, employees may prefer Roth contributions if current income is lower than the threshold. Otherwise, any subsequent distributions would be included in their MAGI and potentially subject their net investment income in a future year to the Additional Investment Tax.

Although commonly referred to as a Medicare tax on investment income, the Additional Investment Tax is not designated for the Medicare Trust Fund, rather it is a tax collected for the General Fund of the US Treasury. As noted above, the tax applies to the lesser of (1) MAGI over a threshold amount based on tax filing status: MAGI above \$200,000 for individuals, \$250,000 for couples filing jointly, and \$125,000 for spouses filing separately, or (2) the sum of investment income.

For example:

A couple filing a joint tax return with MAGI of \$300,000 and \$80,000 of investment income will pay 3.8 percent of \$50,000, that is, \$1,900 in additional taxes.

Investment income

The IRS guidance explains that investment income generally means gross income from interest, dividends, annuities, royalties, rents, and certain net business income. It does not include distributions from qualified retirement plans or arrangements such as pension, profit sharing, or section 401(k) plans, IRAs, 403(b) annuities, or 457(b) arrangements. Also exempt are life insurance proceeds, veterans' benefits, and Social Security benefits. In addition, amounts paid from nonqualified plans for wage withholding purposes, including "interest" that is excluded from FICA wages due to the application of the early inclusion rule, are not subject to the 3.8 percent tax.

The taxable portion of annuity contracts is subject to the new additional tax. Although not specifically covered by the guidance, presumably the tax would not apply to the taxable portion of an annuity purchased by a qualified plan in line with the general rule about qualified plan distributions.

Buck Comment: Even though retirement plan distributions are exempt from the Additional Investment Tax, they do play a role in how the tax is applied. To the extent taxable when paid, these amounts will be included in MAGI and could push that amount over the threshold that causes other income amounts to be taxed.

Application to benefit plan trusts

The proposed regulation says that the Additional Investment Tax does not apply to accounts, funds, or trusts that are exempt from taxation under Subtitle A of the Code. This is true even if subject to tax on unrelated business taxable income. As a result, pension and welfare plan trusts exempt under Code Section 501(a) are exempt from the tax, for example. Grantor trusts, such as those used for trusts set up to fund nonqualified arrangements, are not directly subject to this new tax but the income passes through to the grantor. Taxation would depend on whether the grantor is an individual or a corporation.

In closing

The withholding obligation for the Additional Medicare tax is straightforward. Any amounts paid in excess of \$200,000 will be subject to withholding. The obligation begins January 1, 2013, and employers should ensure that payroll systems are adapted to accommodate the threshold and additional withholding. Employers generally have no obligation to withhold or communicate with employees about the Additional Investment Tax. But in light of the interplay plans may have with individual employee taxation, employers may wish to help employees understand that current benefit plan decisions may have an effect on future taxation.

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