

Client Advisory | April 2010

Increased Medicare Tax on Wages and Self-Employment Income Over Certain Threshold Amounts & New Medicare Tax on Unearned Income of Individuals, Estates and Trusts

The Healthcare and Education Reconciliation Act (the “Act”) was signed into law by the President on March 30, 2010. The Act provides for health insurance reforms affecting millions of Americans. The Act also includes a revenue offset increasing the employee portion of the Medicare tax by 0.9% on wages and self-employment income over certain threshold amounts and imposes a 3.8% Medicare contribution tax on unearned income. Both tax changes are effective for taxable years beginning in 2013.



Karl P. Fryzel
Partner



Kathryn H. Galbraith
Associate

This Client Advisory summarizes the provisions of the Act relating to the increased Medicare tax on wages and self-employment income and the new Medicare tax on unearned income. (All section references are to the Internal Revenue Code (the “Code”) unless otherwise indicated.)

Increased Medicare Tax on High Income Taxpayers. The Federal Insurance Contributions Act (“FICA”) imposes a tax on employers based on the amount of wages paid to an employee during the year. FICA is made up of two parts: the social security tax and the Medicare tax. Under pre-Act law, the social security tax is imposed on employers at a rate of 6.2% on wages up to an annually-adjusted “wage base” (\$106,800 for 2010) and the Medicare tax is imposed at a rate of 1.45% on all wages, regardless of amount (i.e., there is no cap or ceiling). In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (i.e., the combined employer and employee social security tax rate and Medicare tax rate equal 12.4% and 2.9%, respectively). The employee portion of FICA tax generally must be withheld and remitted to the IRS by the employer. Similar to FICA taxes, the Self-Employment Contributions Act (“SECA”) imposes taxes on self-employed individuals with respect to their net income from self-employment. The social security portion of SECA taxes is equal to the combined employer and employee social

security rates (i.e., 12.4%) and applies to self-employment income up to the FICA taxable wage base (\$106,800 for 2010). Similarly, the rate of the Medicare portion is the same as the combined employer and employee Medicare rates (i.e., 2.9%) and there is no ceiling with respect to the amount of self-employment income to which the Medicare tax applies. Under pre-Act law, a self-employed individual is allowed an income tax deduction for one-half of the SECA taxes, analogous to the deduction available to employers for their portion of FICA taxes.

Under the Act, the employee portion of the Medicare tax is increased by an additional 0.9% on wages received in excess of the “threshold amount”. The Act does *not* increase the employer portion of the Medicare tax. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing separately, and \$200,000 in any other case. These threshold amounts are not indexed for inflation. Similarly, the threshold amount for the additional SECA Medicare tax is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing separately, and \$200,000 in any other case. No deduction is allowed for the additional SECA tax.

Unlike the general 1.45% Medicare tax on wages, the additional 0.9% Medicare tax is on the combined wages of the employee and his/her spouse, in the case of a joint return.

As under current law, the employer is required to withhold the additional Medicare tax on wages. However, the employer is only required to withhold the additional 0.9% Medicare tax on wages in excess of \$200,000 that the employee receives from the employer, i.e., the employer may disregard the amount of wages received by the employee's spouse. As a result, where spouses individually make less than the threshold amount (\$200,000) but together make more than the \$250,000 threshold amount for married couples filing jointly, the couple may have to make estimated tax payments to cover the additional 0.9% Medicare tax because neither spouse's employer is required to withhold.

Medicare Tax on Unearned Income.

Under pre-Act law, the Medicare tax applies to wages and self-employment income. Beginning in 2013, however, a Medicare tax will apply to investment income of individuals, estates and trusts. In the case of an individual, the tax is 3.8% of the *lesser* of (i) net

investment income or (ii) the excess of modified adjusted gross income over the threshold amount. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing separately, and \$200,000 in any other case. Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under Section 911(a)(1) of the Code (net of the deductions and exclusions disallowed with respect to the foreign earned income). In the case of an estate or trust, the tax is 3.8% of the *lesser* of (i) undistributed net investment income or (ii) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins (for 2010, the highest estate and trust income tax bracket begins at \$11,200). Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income includes

interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from the disposition of property (other than property held for use in an active trade or business). The tax does not apply to income derived by a sole proprietor, partnership or S corporation engaged in an active trade or business. The tax also does *not* apply to a trust all the unexpired interests in which are devoted to charitable purposes, a trust that is exempt from tax under Section 501 of the Code or a charitable remainder trust exempt from tax under Section 664 of the Code.

As a result of this new Medicare tax, if the Bush administration tax cuts are allowed to expire at the end of 2010, taxpayers above the income thresholds would see the tax on net capital gains jump from the current rate of 15% to 23.8% beginning in 2013. Additionally, the tax on dividend income would jump from the current rate of 15% to 43.4% for individuals in the highest tax bracket.

Note that this Client Advisory highlights only a few of the changes that may affect your organization. If you have any questions regarding the tax law changes summarized in this Advisory or other provisions of the Act, and how these changes and provisions may affect your organization, please contact one of the members of our Tax Department listed below.

BOSTON MA | FT. LAUDERDALE FL | HARTFORD CT | MADISON NJ | NEW YORK NY | NEWPORT BEACH CA | PROVIDENCE RI
STAMFORD CT | WASHINGTON DC | WEST PALM BEACH FL | WILMINGTON DE | LONDON UK | HONG KONG (ASSOCIATED OFFICE)

This advisory is for guidance only and is not intended to be a substitute for specific legal advice. If you would like further information, please contact the Edwards Angell Palmer & Dodge LLP attorney responsible for your matters or one of the following members of the Tax Department:

Karl P. Fryzel, Partner	617.517.5577
Scott Nebergall, Partner	401.276.6461
Steven L. Paul, Partner	617.239.0442
Scott J. Pinarchick, Partner	617.235.5302
Nicholas V. Romanos, Partner	617.239.0379
Kathryn Galbraith, Associate	617.239.0847
Jerome L. Garciano, Associate	617.239.0285

kfryzel@eapdlaw.com
snebergall@eapdlaw.com
spaul@eapdlaw.com
spinarchick@eapdlaw.com
nromanos@eapdlaw.com
kgalbraith@eapdlaw.com
jpgarciano@eapdlaw.com

This advisory is published by Edwards Angell Palmer & Dodge for the benefit of clients, friends and fellow professionals on matters of interest. The information contained herein is not to be construed as legal advice or opinion. We provide such advice or opinion only after being engaged to do so with respect to particular facts and circumstances. The Firm is not authorized under the U.K. Financial Services and Markets Act 2000 to offer UK investment services to clients. In certain circumstances, as members of the U.K. Law Society, we are able to provide these investment services if they are an incidental part of the professional services we have been engaged to provide.

Please note that your contact details, which may have been used to provide this bulletin to you, will be used for communications with you only. If you would prefer to discontinue receiving information from the Firm, or wish that we not contact you for any purpose other than to receive future issues of this bulletin, please contact us at contactus@eapdlaw.com.

© 2010 Edwards Angell Palmer & Dodge LLP a Delaware limited liability partnership including professional corporations and Edwards Angell Palmer & Dodge UK LLP a limited liability partnership registered in England (registered number OC333092) and regulated by the Solicitors Regulation Authority.

Disclosure required under U.S. Circular 230: Edwards Angell Palmer & Dodge LLP informs you that any tax advice contained in this communication, including any attachments, was not intended or written to be used, and cannot be used, for the purpose of avoiding federal tax related penalties, or promoting, marketing or recommending to another party any transaction or matter addressed herein.

ATTORNEY ADVERTISING: This publication may be considered "advertising material" under the rules of professional conduct governing attorneys in some states. The hiring of an attorney is an important decision that should not be based solely on advertisements. Prior results do not guarantee similar outcomes.

EDWARDS
ANGELL
PALMER &
DODGE

eapdlaw.com