

3.8% Surtax on Unearned Income

For tax years beginning after Dec. 31, 2012, a 3.8% surtax applies to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over the threshold amount (\$250,000 for joint filers or surviving spouses, \$125,000 for a married individual filing a separate return, and \$200,000 in any other case). (Code Sec. 1411(a)(1), Code Sec. 1411(b)) MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income under Code Sec. 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). (Code Sec. 1411(d))

Example 1: For 2013, a single taxpayer has net investment income of \$50,000 and MAGI of \$180,000. He won't be liable for the tax, because his MAGI (\$180,000) doesn't exceed his threshold amount (\$200,000).

Example 2: For 2013, a single taxpayer has net investment income of \$100,000 and MAGI of \$220,000. He would pay the tax only on the \$20,000 amount by which his MAGI exceeds his threshold amount of \$200,000, because that is less than his net investment income of \$100,000. Thus, the surtax would be \$760 ($\$20,000 \times 3.8\%$).

Observation: An individual will pay the 3.8% tax on the full amount of his net investment income only if his MAGI exceeds his threshold amount by at least the amount of the net investment income.

Example 3: For 2013, a single taxpayer has net investment income of \$100,000 and MAGI of \$300,000. Because his MAGI exceeds his threshold amount by \$100,000, he would pay the tax on his full \$100,000 of net investment income. Thus, the tax would be \$3,800 ($\$100,000 \times .038$).

The tax is taken into account in determining the amount of estimated tax that an individual must pay, and is not deductible in computing an individual's income tax. (Code Sec. 6654(f), Committee Report)

What is net investment income? For purposes of the Medicare contribution tax, "net investment income" means the excess, if any, of:

(1) the sum of:

... gross income from interest, dividends, annuities, royalties, and rents, unless those items are derived in the ordinary course of a trade or business to which the Medicare contribution tax *doesn't* apply (see below),

... other gross income derived from a trade or business to which the Medicare contribution tax *does* apply (below),

... net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the Medicare contribution tax *doesn't* apply, over

(2) the allowable deductions that are properly allocable to that gross income or net gain. (Code Sec. 1411(c))

Trades and businesses to which tax applies. The 3.8% surtax applies to a trade or business if it is a Code Sec. 469 passive activity of the taxpayer, or a trade or business of trading in Code Sec. 475(e)(2) financial instruments or commodities. (Code Sec. 1411(c)(2)) For a taxpayer that does engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include the above items, plus the gross income (minus allocable deductions) from the passive activity or trading business.

Investment income won't include amounts subject to self-employment tax. Specifically, net investment income won't include any item taken into account in determining self-employment income and subject to the self-employment Medicare tax under Code Sec. 1401(b). (Code Sec. 1411(c)(6))

Observation: Thus, the same item of income can't be subject to both self-employment tax and the Medicare contribution tax. If self-employment tax applies, the Medicare contribution tax won't apply.

The tax doesn't apply to trades or businesses conducted by a sole proprietor, partnership, or S corporation. But income, gain, or loss on working capital isn't treated as derived from a trade or business and thus is subject to the tax. (Code Sec. 1411(c)(3), Committee Report)

Exception for certain active interests in partnerships and S corporations. Gain or loss from a disposition of an interest in a partnership or S corporation is taken into account by the partner or shareholder as net investment income only to the extent of the net gain or loss that the transferor would take into account if the entity had sold all its property for fair market value immediately before the disposition. (Code Sec. 1411(c)(4))

Retirement plan distributions. Investment income doesn't include distributions from tax-favored retirement plans, such as qualified employer plans and IRAs. (Code Sec. 1411(c)(5))

Application to estates and trusts. For an estate or trust, the tax is 3.8% of the lesser of: (1) undistributed net investment income or (2) the excess of AGI (as defined in Code Sec. 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. (Code Sec. 1411(a)(2))

Exceptions and special rules. The tax does not apply to a nonresident alien or to a trust all the unexpired interests in which are devoted to charitable purposes, a trust that is exempt from tax under Code Sec. 501, or a charitable remainder trust exempt from tax under Code Sec. 664. (Code Sec. 1411(e))

.9% Surtax on Earned Income

For tax years beginning after Dec. 31, 2012, a 3.8% surtax applies to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over the threshold amount (\$250,000 for joint filers or surviving spouses, \$125,000 for a married individual filing a separate return, and \$200,000 in any other case).

The IRS has released new guidance, in question and answer format, on the 0.9% additional Medicare tax. Among other items, the guidance reveals that:

- All wages that are currently subject to Medicare tax are also subject to the additional Medicare tax if they are paid in excess of the applicable threshold for an individual's filing status.
- The additional Medicare tax applies to employees who are nonresident aliens or U.S. citizens living abroad if their wages exceed the applicable thresholds.
- An employer must begin withholding the additional Medicare tax once an employee's wages are over the threshold.
- An employer need not notify an employee when it begins withholding the additional Medicare tax.
- An employer begins withholding the additional Medicare tax in the pay period in which it pays wages to the employee exceeding the \$200,000 threshold and not earlier, even if the employee's annual wages are expected to exceed the threshold.

Click on the following link for more information on the .9% surtax on earned income: **["IRS's Questions and Answers for the Additional Medicare Tax"](#)**