

new medicare tax

planningMATTERS • with pwv law

applies in 2013 STRATEGIES FOR MINIMIZING THE COST

BACKGROUND

Tax Prior to the Health Care Act. Prior to the 2010 Health Care Act, wages were subject to FICA at the rate of 6.2% on the employer and 6.2% on the employee (although the employee rate was reduced to 4.2% in 2011 and 2012) up to a threshold amount of wages (\$110,100 in 2012). The Medicare tax was imposed at the rate of 1.45% on both the employer and the employee with all wages being subject to Medicare. For those with net earnings from self-employment ("NESE"), self-employment tax was imposed at the rate of 12.4% (reduced to 10.4% in 2011 and 2012) up to the annual threshold and 2.9% on all net earnings from self-employment tax with no threshold.

2010 Act – Impact on Medicare Tax January 1, 2013.

The 2010 Health Care Act increased the Medicare portion of the self-employment tax by .9% (to 3.8%) on earnings (wages or net earnings from self-employment) in excess of \$250,000 for taxpayers filing jointly and \$200,000 for other taxpayers. The Act also subjects investment income to the Medicare tax. This is the first time in history that investment income has been subject to the Medicare tax. As of January



by mary e. vandennack

1, 2013, the 3.8%

Medicare tax is

imposed on investment income to the extent that modified adjusted gross income exceeds \$250,000/\$200,000.

Net Investment Income ("NII"). NII includes interest, dividends, royalties, and rents other than those derived in the ordinary course of a trade or business. NII also includes any net gain attributable to the disposition of property not held in a trade or business. Items of interest, dividends, annuities, royalties, rents, and gains, which pass through a flow-through entity to its owners will retain the character of investment income and be subject to the tax.

Who Will Be Affected by the Tax? Sole proprietors and owners of single member LLC's with active businesses will be subject to the surtax. The new tax will apply to undistributed NII of estates and trusts on income subject to the highest tax bracket. Partnership income is likely to be subject to either the surtax or the tax on NII. S corporation distributions from a business in which an owner material participates is the one exception at present.

PLANNING STRATEGIES

Use S Corporations to Operate Business. For shareholders who materially participate in the business, it appears that such shareholders can avoid the surtax on earned income and the 3.8% tax on net investment income. The caveat is that such a shareholder should take a reasonable salary from the S corporation. Net gains on the sale or redemption of the shareholder's interest in the S corporation should also be exempt. If you are starting a new business or currently own an LLC, consider whether making an S election is advisable.

Overall Business Structure. Review your overall business structure. Consider whether an S corporation can be used in the mix. This may work where an LLC electing partnership tax treatment owns real estate. Such an LLC can pay management fees to an S corporation. In a limited partnership arrangement, evaluate the possibility of an S corporation general partner.

There are a variety of strategies to minimize the new Medicare tax. Review your entire income picture to identify exposures to the new tax and possible reduction.

For more information visit www.pwvlaw.com