CONGRESSIONAL HEALTH CARE CAUCUS

New 3.8% Medicare Tax on "Unearned" Net Investment Income

Net investment income- Income received from investment assets such as bonds, stocks, mutual funds, loans and other investments

Capital gain- When a capital asset is sold, the difference between the basis in the asset and the amount it is sold for (or a **capital loss** if it is sold for less)

Basis- the cost of an asset which includes the purchase price, shopping, installation, and other services associated with the asset

Adjusted gross income (AGI) - measure of income used to determine how much of your income is taxable and is calculated as your gross income from taxable sources minus allowable deductions, such as unreimbursed business expenses, medical expenses, alimony and deductible retirement plan contributions.

You have a capital gain if you sell the asset for more than your basis. You have a capital loss if you sell the asset for less than your basis.

Where is the 3.8% tax found and when will it take effect?

Section 1402 of the Health Care and Reconciliation Act of 2010, which amends the Patient Protections and Affordable Care Act, outlines the new unearned income Medicare tax, and goes into effect January 1, 2013.

Who is subject to this tax?

Taxpayers with incomes or an **adjustable gross income (AGI)** over $200,000 who file individually or $250,000 for married couples filing jointly could be subject to this tax. The provision imposes a 3.8 percent tax (identical to the combined employer/employee tax rates on earned income) on income from interest, dividends, annuities, royalties and rents which are not derived in the ordinary course of trade or business, excluding active S corporation or partnership income. Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, which are excluded from gross income under the income tax. If capital gains on a primary home sale exceed $250,000 for individuals or $500,000 for a married couple, and the income threshold is met, the excess realized gain is subject to the 3.8% tax.

How does this relate to the sale of a home?

There is no sales tax on home sales in the Reconciliation Act; instead, there is a tax which includes capital gains, rents, dividends and interest income that will only apply to taxpayers under limited conditions.

When determining if an individual or a couple is subject to the 3.8% tax:

- A home sale MAY result in a capital gain that increases **net investment income**
- A home sale MAY result in a capital gain that increases a taxpayer's **AGI**

NOTE: When selling a home any profit is considered **capital gain** resulting in a taxpayer's possible eligibility to qualify for the 3.8% unearned income tax.

How is this different from the Medicare payroll tax?

Unlike the Medicare payroll tax, this is an unearned income tax. Unearned income is the income that an individual derives from investing capital. It includes capital gains, rents, dividends and interest income.

How does this pertain to the sale of a primary home?

For the majority of people selling their primary residence this tax will not apply.

Any gain from the sale of a principal residence that results in a **capital gain** that is less than $250,000 (individual) or $500,000 (joint return) will continue to be excluded from taxation. The new 3.8% tax does not apply to the current excluded amounts for the **capital gains** of a primary home sale.

The new Medicare tax would apply only to any gain realized that is more than the $250,000/$500,000 existing primary home exclusion (known as the "taxable gain"), and only if the seller has adjustable gross income (**AGI**) above the $200,000/$250,000 **AGI** thresholds. In such cases, taxpayers pay the tax on the amount of money that exceeds the capital gain ($500,000 for married couples, $250,000 for individuals) or a factor of their **AGI** as deatiled in the formula below.

The tax is not imposed on the total **AGI**, nor is it imposed solely on the investment income. Rather, the taxable amount will depend on the operation of a formula. The taxpayer will determine the **LESSER** of (1) net investment income **OR** (2) the excess of **AGI** over the $200,000/$250,000 **AGI** thresholds. Thus, if net investment income is the lesser amount, then the 3.8% tax is applied only to the net investment income amount. If the excess over the thresholds is the smaller amount, then the 3.8% tax would apply only to the excess amount.

STEP ONE

- The tax will apply to taxpayers with an **AGI** in excess of $200,000 if single or $250,000 if married if they also have unearned income.
- NOTE: Unearned income includes **capital gains** which is why this could apply to the sale of a home.

Ex) A single individual has a salary of $220,000 which is in excess of the $200K threshold, therefore they could be subject to the tax if they have unearned income.

Ex) A married couple has a combined salary of $295,000 which is in excess of the $250K threshold, therefore they could be subject to the tax if they have unearned income.

Ex) A married couple has a salary of $200,000, although their salary alone doesn't meet the income threshold, they could still be subject to the tax if their **capital gain** is at least $50,000. It is important to remember to add the salary with the **capital gain** to determine the total **AGI**. If the sum of the two for this couple is more than $250,000, they are subject to the tax.

Ex) A single individual has a salary of $80,000 which is less than the $200K threshold, therefore he is not automatically subject to the tax. However, he could still be subject to the tax depending on if he has a **capital gain** and the amount added to his income amounts to more than $200K (individual threshold).

STEP TWO

- Currently, a taxpayer who sells their <u>primary</u> residence is excluded from taxation on any **capital gain** up to $250,000 if single or $500,000 if married on the sale of their home

- If a couple sells their <u>primary</u> residence for a **capital gain** of more than the $250K/$500K threshold, the difference is added to their **AGI**

    Ex) A couple sells their house for $800,000 and net a **capital gain** of $600,000. You must take the $600K (amount of **capital gain**) and subtract $500K (tax exemption for a couple) resulting in $100,000 which will be added to their **AGI**. If the couple has a combined salary of $160,000 (under the $250K income threshold) they are still subject to the tax since the combined salary is added to the **capital gain** resulting in a total of $260,000. ($160,000 of combined salary + $100,000 of **capital gain**) which meets the income threshold for couples filing jointly ($250K).

    Ex) A couple has a combined salary of $275,000 and sells their house for $400,000 and net a **capital gain** of $30,000. Even though the couple meets the $250K income threshold, since the couple sold their house for less than the $500K **capital gain** exemption threshold, there is nothing added to their **AGI**, thus no tax.

STEP THREE

- For those who qualify to pay the tax, the amount of tax owed will be equal to 3.8% multiplied by the lesser of (1) **net investment income** or (2) the amount by which their **AGI** exceeds the $200K/$250K threshold.

Tax= 3.8% x [lesser of (AGI- $200K/$350K or net investment income)]

What this actually means for the sale of a PRIMARY home

- A single individual with salary of $100,000 a year sells his house for $270,000 with a **capital gain** of $50,000.
    - To determine his **AGI**: add his salary of $100,000, to his **capital gain** ($100,000 salary + $50,000 capital gain) is less than the $250K allowed for a single person selling their primary residence there is no added capital gain to his salary.
    - Since his **AGI** falls below the $200K threshold for a single individual, he is NOT subject to the tax

- A couple with a combined salary of $260,000 a year, which meets the initial income requirement, and sells their house for $1.2 million with a **capital gain** of $700,000.
    - To determine their **AGI**: add their combined salary of $260,000 to $200,000 ($700,000 capital gain- $500,000 tax exclusion for couples). Their resulting **AGI** is $460,000. Since their **AGI** is above the $250K threshold they are subject to the tax.
    - To determine how much tax they pay you must compare the two options and take the lesser of the two
        - Amount **AGI** exceeds income threshold: $460,000 - $250,000 = $210,000
        - **Net investment income** (capital gain above capital gain exclusion): $700,000 - $500,000 = $200,000
    - Therefore, since the lesser is the **net investment income** that is what the 3.8% tax is applied
        - $200,000 x 3.8% = total tax of $7,600

What happens if I have other properties?

If all of your income is derived from real estate investments that you own and operate, you are not subject to the 3.8% tax. You property is considered your "trade or business" and although you are not responsible for the 3.8% tax you could be responsible for a tax on the earned income.

If you use rental properties for an investment, then they are not considered a trade or business, no matter the income you bring in. Rental homes that have been rented for more than 14 days could be subject to the new 3.8% tax, assuming that you meet the $200,000/$250,000 **AGI** threshold.

In the sale of a secondary home there is no tax exclusion for the first $250,000/$500,000 of a **capital gain.**

    Ex)A couple has a combined income of $2 million a year and sells their vacation home for $1.2 million and net a **capital gain** of $700,000.

To determine their **AGI** since the income threshold has been met: There is NO tax exclusion since this is a secondary residence. Therefore, add their combined salary ($2 million) to their **capital gain** ($700,000) which results in an **AGI** of $2.7 million.

- To determine how much tax they pay you must compare the two options and take the lesser of the two.
  - Amount **AGI** exceeds income threshold: $2.7 million - $250,000 = $2.45 million
  - **Net investment income** (capital gain above capital gain exclusion): $700,000 - $0 (no exclusion) = $700,000
- Therefore, since the lesser is the **net investment income** that is what the 3.8% tax is applied.
  - $700,000 x 3.8% = total tax of $26,600

Ex) A single individual with an income of $120,000, which is under the $200K income threshold, sells his vacation home for $750,000 and nets a **capital gain** of $250,000.

- Note: the income threshold has NOT been met (his salary of $120K falls below the $200K threshold).
- However, since there is no exclusion for secondary homes his **capital gain** is the full $250,000, which is added to his **AGI** and will push him over the $200K threshold ($120,000 income + $250,000 **capital** gain = **AGI** of $370K). He is now subject to the tax.
  - Amount **AGI** exceeds income threshold: $370,000-$200,000 = $170,000
  - **Net investment income** (capital gain above capital gain exclusion): $250,000 - $0 (no exclusion) = $250,000
- Therefore, since the lesser is the **AGI** that is where the 3.8% tax is applied.
  - $170,000 x 3.8% = total tax of $6,460

The unearned income tax applies to all capital gains, not only home sales

Ex) A couple with a combined salary of $260,000, which is over the $250K income threshold for married couples, have $50,000 in dividend and interest income (which is a **capital gain**). Therefore, add their combined salary ($260,000) to their **capital gain** ($50,000) which results in an **AGI** of $310,000.

- Since their **AGI** of $310,000 is above the income threshold of $250K for married couples they are subject to the 3.8%tax
  - Amount **AGI** exceeds income threshold: $310,000-$250,000=$60,000
  - Since this is not a primary property sale, there is no exclusion.
- Therefore, to determine the tax the couple will be subject to the amount the **AGI** exceeds the income threshold ($60K) is multiplied by 3.8%.
  - $60,000 x 3.8% tax = total tax of $2,280

Ex) A single individual with a salary of $70,000, which is under the $200K income threshold for single individuals has received annuities for $60,000 (which is a **capital gain**). Therefore, after adding his salary ($70,000) to his **capital gain** ($60,000) resulting in a total of $130,000, he is not subject to the 3.8% tax since $130,000 falls below the individual income threshold of $200,000.

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