Understanding the Medicare Tax for High Earners

Presented by Christa Canavan

The Federal Insurance Contributions Act (FICA) applies a social security tax and Medicare tax to earned income. The Medicare portion of the FICA tax is 2.9 percent. There are two other Medicare taxes that apply to incomes above certain thresholds. One is the Additional Medicare Tax of 0.9 percent, and the second is the Unearned Income Medicare Contribution Tax (commonly called the Net Investment Income Tax) of 3.8 percent. Certain high-income individuals can be subject to both the Additional Medicare Tax and the Net Investment Income Tax, though the Additional Medicare Tax applies to earned income and the Net Investment Income Tax applies to unearned income.

The Medicare FICA Tax and the Additional Medicare Tax

The Medicare FICA tax of 2.9 percent applies to employee wages and net self-employment income. Unlike the social security portion of FICA, which has a “wage base” ceiling, the Medicare portion of FICA has no compensation limit. Each dollar earned is subject to the Medicare portion of the FICA tax. If you are employed, half of the Medicare FICA tax (1.45 percent) will be paid by your employer and you will pay the other half (1.45 percent). If you are self-employed, you will pay the full 2.9 percent Medicare tax.

The Additional Medicare Tax of 0.9 percent is levied on wages and self-employment income above certain thresholds. Only the employee or the self-employed individual pays the Additional Medicare Tax. Employers do not pay a portion of the Additional Medicare Tax. The income thresholds for the Additional Medicare Tax by filing status are: $200,000 (single), $250,000 (married), or $125,000 (married but filing separately).

Wage earners above those thresholds will pay Medicare taxes of 2.35 percent. This percentage includes the employee’s portion of Medicare FICA tax, 1.45 percent, plus the 0.9 percent Additional Medicare Tax. Self-employed individuals will pay both the total Medicare FICA tax of 2.9 percent plus the 0.9 percent Additional Medicare Tax, for a total of 3.8 percent.

Net Investment Income Tax

The 3.8 percent Medicare tax is a separate tax that applies to most net investment income when a taxpayer’s modified adjusted gross income (MAGI) exceeds certain thresholds. Like the Additional Medicare Tax, the thresholds are based on filing status and are the same amounts: $200,000 (single), $250,000 (married), or $125,000 (married but filing separately).

The following types of investment income are affected:

- Taxable interest
- Capital gains
- Dividends
- Nonqualified annuity distributions
- Royalties
- Rental income
- Personal residences with appreciation greater than $250,000 ($500,000 if married)

Retirement income including pension, 401(k), and IRA distributions and social security benefits are not subject to the Net Investment Income Tax. It also does not apply to municipal bond income. Keep in mind, however, that distributions from retirement accounts can increase your MAGI over a threshold and subject your investment income to the 3.8 percent tax.

The law also applies to estates and most trusts that are not grantor trusts. The most common type of grantor trust is a revocable trust. The threshold for estates and trusts is the amount at which their highest tax bracket begins.

Calculating the Net Investment Income Tax
The 3.8 percent Net Investment Income Tax is applied to the lesser of net investment income or the excess of MAGI over the applicable threshold ($200,000 for single filers, $250,000 for married filers, and $125,000 for married filing separately).

Example: Mark and Sue have earnings from wages of $175,000 and investment earnings of $100,000. The couple's total wages and investment earnings (MAGI) equal $275,000. The 3.8 percent Net Investment Income Tax will be applied to the lesser of net investment income ($100,000) or the excess of MAGI over the applicable threshold ($25,000). In Mark and Sue's case, only $25,000 will be subject to the Net Investment Income Tax. The entire $100,000 in investment income will be subject to either capital gains or ordinary income tax, depending on the nature of the income.

How Can You Plan Around the Medicare Tax?
If you believe that your income tax rate will be higher in the future than it is today, you may want to consider taking an action to minimize the impact. One option might be a Roth IRA.

Roth IRA conversions. Roth IRAs have become popular alternatives to traditional IRAs. Not only does money held in a Roth IRA grow tax deferred for federal income tax purposes, but the account owner does not have to take a minimum distribution each year and distributions are tax free if certain requirements are met. (**Please note:** State tax treatment of Roth IRAs differs. Consult your tax advisor about your state's rules.) Thus, you may avoid having retirement distributions increase your adjusted gross income over the threshold and exposing other income to the Medicare surtax.

If a Roth IRA makes overall financial sense for you, you can convert a traditional IRA to a Roth IRA. When you convert to a Roth IRA, you pay income tax on the taxable dollars that are converted. These taxes are due in full in the year of conversion. Paying taxes on the conversion today may allow future distributions to escape scheduled tax increases later. It is generally better to pay these taxes with funds from another account; using IRA assets will typically result in more taxes and may involve early withdrawal penalties, depending on your age.

For more information on how the Medicare tax may affect you and your family, please contact us.

This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.

Norton Financial Consultants

Christa Canavan, ChFC, Registered Investment Advisor
Norton Financial Consultants
165 Main Street, Suite 206-A | Medway, MA 02053
508.429.7000 | 508.429.7409 fax | www.nortonfinancial.com | christa@nortonfinancial.com