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IRS Releases Guidance For Employers and Others on the 2013 Medicare Taxes under the Affordable Care Act

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On November 30, 2012, the Internal Revenue Service ("IRS") released proposed regulations and two sets of frequently asked questions implementing two new Medicare taxes under the Patient Protection and Affordable Care Act ("ACA") that are effective starting in 2013. The proposed regulations were published in the December 5, 2012 Federal Register, and are intended to offer guidance for both employers and individuals on how to implement the new taxes.[1]

This guidance is important for employers to know and understand because beginning in 2013, they will be responsible for collecting ACA's new Medicare tax, a 0.9% increase in the Federal Insurance Contributions Act ("FICA") tax on high earners. This additional 0.9% Medicare tax must be collected on all wages paid to employees over $200,000 ("Additional Medicare Tax"). Employers should also familiarize themselves with the other new ACA tax, a non-payroll tax on investment income, as high income individuals are likely to inquire as to any interplay between the two new taxes.

Note: Both taxes apply only to "high earners"—generally individuals earning in excess of $200,000 annually ($125,000 if married filing separately, or $250,000 if filing jointly).

0.9% FICA Tax on Wage Income (Additional Medicare Tax)

Starting in 2013, ACA increases the hospital insurance (i.e., Medicare) tax portion of FICA by 0.9% for wages in excess of $200,000 ($125,000 if married filing separately, or $250,000 if filing jointly). The Additional Medicare Tax applies only to the employee's share of FICA; there is no employer match. Under current law, FICA is comprised of a 6.2% Social Security tax and a 1.45% Medicare tax. (For 2011 and 2012, the 6.2% Social Security tax has been lowered to 4.2%; however, it is set to revert to 6.2% in 2013 unless extended by Congressional action.) The 6.2% is assessed only up to the maximum taxable wage base, which is $113,700 in 2013. The new 0.9% Additional Medicare Tax will apply on wages over $200,000 ($125,000 if married filing separately, or $250,000 if filing jointly), and is imposed without limitation (there is no maximum taxable wage base for purposes of the Additional Medicare Tax).

All employers must begin to withhold the Additional Medicare Tax on wages paid to employees in excess of $200,000 in a calendar year, regardless of the employee's filing status. In other words, employers will not have to determine whether an employee is married and filing jointly or separately or how much a married employee's spouse might earn.

Because of this rule, employers' withholding obligations are somewhat straightforward: withholding of the Additional Medicare Tax applies when an employee is paid taxable wages in excess of $200,000, even though the employee may not be liable for Additional Medicare Tax (based on the employee's actual filing status).

Example: If the employer pays an employee $220,000 and the employee's wages together with that of his or her spouse do not exceed the $250,000 threshold for joint return filers, then the employee's wages in excess of $200,000, namely $20,000, would not be subject to the Additional Medicare Tax. Nevertheless, the employer will still have to meet its obligations under ACA by withholding the Additional Medicare Tax from the employee's $20,000 in wages over the $200,000 withholding threshold. In this example, the employee will take a credit for the withheld Additional Medicare Tax credited against the total tax liability shown on his or her income tax return (Form 1040) for that year.

Unlike the general Medicare tax, there is no employer matching FICA amount on the Additional Medicare Tax.

Employers must begin withholding the Additional Medicare Tax in the pay period in which an employee's wages are first in excess of $200,000, during a calendar year. To the extent an employer pays an employee a single payment of wages in excess of $200,000, the employer must withhold Additional Medicare Tax on the amount in excess of the $200,000 withholding threshold, taking into account other wages paid by the employer to the employee in the calendar year.

Example: If an employer has paid its employee $180,000 in wages through November 30, 2013, and on December 1, 2013, the employer pays the employee a bonus of $50,000, then the employer must withhold Additional Medicare Tax on $30,000 of the $50,000 bonus and may not withhold Additional Medicare Tax on the other $20,000. The employer must also withhold Additional Medicare Tax on any other wages paid in December 2013.

If an employer employs two employees who are married to each other, the employer should not combine the wages it pays to the two employees to determine whether to withhold any Additional Medicare Tax. The withholding threshold amount of $200,000 is applied per employee, per calendar year.

Employees who may owe more than the amount withheld by their employer (which could occur depending on the individual's filing status, wages, compensation, and self-employment income) should be advised to make estimated tax payments and/or request additional income tax withholding using Form W-4. However, there is no requirement for the employer to provide notice to employees about the Additional Medicare Tax.

An employer that fails to deduct and withhold the Additional Medicare Tax is still liable for the tax unless the tax that the employer failed to withhold from its employee's wages is otherwise paid by the employee. However, an employer that does not meet its withholding, deposit, reporting, and payment responsibilities for Additional Medicare Tax may be subject to applicable penalties for these failures, even if not liable for the tax itself (i.e., even if the employee pays the tax).

Although the proposed regulations will not be effective until after the Additional Medicare Tax withholding obligation commences, because the regulations are subject to a notice and comment period before being finalized and published in the Federal Register, the IRS clarified that employers may rely on the proposed regulations before the proposed regulations are finalized and published in the Federal Register. Moreover, to the extent final regulations modify the proposed regulations, the modified rules will apply prospectively with respect to future withholdings by employers.

The guidance also addresses various other issues related to withholding the Additional Medicare Tax on other forms of compensation such as noncash wages, tips, and nonqualified deferred compensation ("NQDC"). Generally, the same rules used to determine the employer's regular Medicare tax withholding obligations on these forms of compensation are followed for determining the Additional Medicare Tax. So, for example, an employer would calculate wages for purposes of withholding Additional Medicare Tax from NQDC in the same way that it calculates wages for withholding the existing Medicare tax from NQDC. If an employee has amounts deferred under a nonqualified deferred compensation plan and the NQDC is taken into account as wages for FICA tax purposes under the special timing rules applicable to NQDC, the NQDC would likewise be taken into account under the special timing rule for purposes of determining an employer's obligation to withhold Additional Medicare Tax.

3.8% FICA Tax on Investment Income (Net Investment Income Tax)

In addition to the 0.9% Additional Medicare Tax discussed above, ACA introduced a new, non-payroll-based Medicare tax effective starting in 2013. This new Medicare tax of 3.8% applies to the lesser of (A) net investment income (defined below) or (B) the excess of modified adjusted gross income ("AGI") over $200,000 ($125,000 if married filing separately, or $250,000 for joint filers). (For most typical taxpayers, modified AGI is simply their AGI.)

As with the Additional Medicare Tax, this tax on investment income will apply to investment income in excess of the thresholds on an uncapped basis. Also, these threshold amounts are not indexed to inflation, which means that this tax may apply to more taxpayers in future years.

For these purposes, in general, "net investment income" is the excess of gross income from interest, dividends, annuities, royalties, rents, passive activity income and capital gains, over any deductions allowed by the IRS that are allocated to such income. As such, net investment income does not include, for example, tax-exempt interest or distributions from tax qualified plans. Notional earnings from NQDC are generally not included in "net investment income" because there is no amount included in gross income at the time those notional earnings are credited to the employee's notional account. Moreover, distributions from NQDC (including amounts deemed as earnings) are specifically not included as investment income under the proposed regulations. (Note, however, that amounts deferred under a NQDC arrangement are generally includable as "wages" for Medicare tax purposes as explained above, subject to the special timing rules for these amounts.) Also, the 3.8% Medicare tax does not apply to income from the sale of an interest in a partnership or S corporation, to the extent that gain of the entity's property would be from an active trade or business. The 3.8% Medicare tax applies to income from a passive activity or from a trade or businesses of trading in financial instruments or commodities.

Individuals who may be subject to this 3.8% Medicare tax should consult with their personal tax advisor to determine if it might be advantageous to recognize capital gains in 2012, thus avoiding the 3.8% tax on these gains. This also may be attractive in light of the possibility of the maximum federal income tax rate increasing to 39.6% in 2013 and thereafter.

Example: Assume a married couple (joint filers), sell their principal residence that they have owned and resided in for the last 20 years for $1 million. Further assume their cost basis in the home is $400,000 (their realized gain on the sale is $600,000). The recognized gain subject to regular income taxes is $100,000 ($600,000 realized gain less the $500,000 permitted primary residence exclusion). The couple's modified AGI is $300,000 and exceeds the threshold amount of $250,000 by $50,000. They are subject to a 3.8% FICA tax on the lesser of $100,000 (their net investment income) or $50,000 (the amount that their modified AGI exceeds the $250,000 threshold for joint filers). In the example, the couple owes a 3.8% FICA tax of $1,900 ($50,000 × 3.8%).

Both sets of proposed regulations and FAQs contain detailed instructions and rules regarding the application of these new taxes. Employers should direct employees to consult with their personal tax advisers if they have any questions on how to report, pay or adjust for these taxes on their income tax return (Form 1040). Please contact your Proskauer lawyer or any member of our Health Care Reform Task Force should you have questions regarding the above.

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Disclaimer: All examples are for illustration purposes only. Actual income may vary based on an individual's specific facts and circumstances.

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[1] The text of the regulations and FAQs can be found here:

Additional Medicare Tax

FAQ: http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax

Rule: http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29237.pdf

Net Investment Income Tax

FAQ: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs

Rule: http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf