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Higher Medicare Taxes on HIGH-INCOME TAXPAYERS in the 2010 Health Reform Legislation

High-income taxpayers will be hit with two big tax hikes under the recently enacted health overhaul legislation: a tax increase on wages and a new levy on investments.

To help offset the cost of providing health insurance to millions of Americans, the new law imposes an additional 0.9% Medicare tax on wages above $200,000 for individuals and $250,000 for married couples filing jointly. In addition, for higher-income households, the new law adds a 3.8% tax on unearned income, including interest, dividends, capital gains and other investment income.

Higher Medicare tax on wages and self-employment income. The Medicare tax is the primary source of financing for Medicare's hospital insurance trust fund, which pays hospital bills for beneficiaries who are 65 and older or disabled.

Under current law, wages are subject to a 2.9% Medicare tax. Workers and employers pay 1.45% each. Self-employed people pay both halves of the tax (but are allowed to deduct half of this amount for income tax purposes).

Unlike the payroll tax for Social Security, which applies to earnings up to an annual ceiling ($106,800 for 2010), the Medicare tax is levied on all of a worker's wages without limit.

Under the provisions of the new law, which take effect in 2013, most taxpayers will continue to pay the 1.45% Medicare tax, but single people earning more than $200,000 and married couples earning more than $250,000 will be taxed at an additional 0.9% (2.35% in total) on the excess over those base amounts. Self-employed persons will pay 3.8% on earnings over those thresholds.

It should be noted that the $200,000/$250,000 thresholds aren't indexed for inflation, so it is likely that more and more people will be subject to the higher tax in coming years.

Employers will collect the extra 0.9% on wages exceeding $200,000 just as they would withhold Medicare taxes and remit them to the IRS. However, companies won't be responsible for determining whether a worker's combined income with his or her spouse made them subject to the tax.

Instead, some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid. Married couples with combined incomes approaching $250,000 will have to keep tabs on both spouses' pay to avoid an unexpected tax bill.

Medicare tax extended to investments. Under current law, the Medicare tax only applies to wages and self-employment income. Beginning in 2013, a Medicare tax will, for the first time, be applied to investment income. A new 3.8% tax will be imposed on net investment income of single taxpayers with AGI above $200,000 and joint filers over $250,000 (unindexed).

Net investment income is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). Net investment income is reduced by the deductions that are allocable to that income. However, the new tax won't apply to income in tax-deferred retirement accounts such as 401(k) plans.

Because the new tax on investment income won't take effect for three years, that leaves more time for Congress and the IRS to tinker with it. So we can expect lots of refinements and "clarifications" between now and when the tax actually takes hold in 2013.

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