National Association of REALTORS® Government Affairs Division
500 New Jersey Avenue, NW, Washington DC, 20001

NEW MEDICARE TAX ON "UNEARNED" NET INVESTMENT INCOME

Q: Who will be subject to the new taxes imposed in the health legislation?

A: A new 3.8% tax will apply to the "unearned" income of "High Income" taxpayers. Another 0.9% tax will apply to the "earned" income of these same individuals. Both are referred to as "Medicare" taxes.

Q: Who is a "High Income" Taxpayer?

A: Those whose tax filing status is "single" will be subject to the new taxes if they have Adjusted Gross Income (AGI) of more than $200,000. Married couples filing a joint return with AGI of more than $250,000 will also be subject to the new tax. (The AGI threshold for married filing separate returns is $125,000)

Q: When does the new 3.8% Medicare tax take effect?

A: The new Medicare tax on unearned income will take effect January 1, 2013.

Q: What is "unearned" net investment income? A: Unearned income is the income that an individual derives from investing his/her capital. It includes capital gains, rents, dividends and interest income. It also comes from some investments in active businesses if the investor is not an active participant in the business.

The portion of unearned income that is subject both to income tax and the new Medicare tax is the amount of income derived from these sources, reduced by any expenses associated with earning that income. (Hence the term "net" investment income.) Thus, in the case of rents, the taxable amount would be gross rents minus all expenses (including depreciation) incurred in operating the rental property.

Q: So the new tax will apply to rents from investment properties that I own?

A: Maybe. Remember that net investment income includes only net rental income. Thus, gross rents would not be subject to the tax. Rather, gross rents would be reduced (as they are under the income tax) by all allowable expenses, including depreciation, cost of repairs, property taxes and all other expenses related to the property. AGI includes net income from rent, so if your AGI is above the $200,000/$250,000 thresholds, then the rental

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income might be subject to the tax. (See Q-7, below. See also Q-9 and Q-10, related to losses and to vacation homes, below.)

Q: Does the tax apply to the yearly appreciation of an asset?

A: No. Capital gains are subject to this new tax only in the year when the asset is sold. The amount of the gain is measured for purposes of this new tax in the same way that it is for income tax purposes. This rule applies to both real estate and securities and other capital assets. Net capital gains are taxable only in the year of sale.

Q: How is the new 3.8% Medicare tax calculated? A: The new 3.8% Medicare tax is assessed only when Adjusted Gross Income (AGI) is more than $200,000/$250,000. (See Q-2 above.) AGI includes net income from interest, dividends, rents and capital gains. 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 smaller amount, then the 3.8% tax is applied only to the net investment income amount.

If the excess over the threshold is the smaller amount, the tax applies to that excess. For example, if AGI for a single individual is $275,000, then the excess over $200,000 would be $75,000. If, in this example, $75,000 is less than the individual's net investment income, then the 3.8% tax would be applied to the $75,000. If net investment income is the smaller amount, then the lesser net investment income amount would be subject to the 3.8% tax.

Q: Will the $250,000/$500,000 exclusion on the sale of a principal residence continue to apply? Will the 3.8% tax apply to the excluded amount?

A: Any gain from the sale of a principal residence that is less than $250,000 (individual) or $500,000 (joint return) will continue to be excluded from the income tax. Similarly, the new 3.8% tax will NOT apply to the excluded amount of the gain. The new Medicare tax would apply only to any gain realized that is more than the $250K/$500K existing primary home exclusion, and only if the seller has AGI above the $200K/$250K AGI thresholds. So, for example, if the taxable portion of a gain was $30,000 and a married couple had AGI (which would include the taxable gain) of $240,000, the 3.8% tax would not apply because AGI is less than $250,000. If that same couple had AGI of $290,000, then the application of the 3.8% tax would be subject to the same formula described above. The $30,000 gain on the sale is less than the $40,000 excess above $250,000 AGI, so the $30,000 gain is subject to the new 3.8% tax.

Q: Is rent from a vacation home subject to the 3.8% tax? And what about the gain on sale?

A: The application of the tax will depend on whether the vacation home has been rented out and also used for the personal enjoyment of its owner. If the owner has rented the home out to others, then the 14-day rent exclusion will apply. If the home has been rented for more than 14 days, then the rents (minus related expenses) would be considered as part of net investment income and could, depending on the calculation described above, be subject to the new tax.

If the vacation home has been used solely for personal enjoyment (i.e., there is no rental income and no associated expenses), then a gain on sale would likely be treated as net investment income and would be subject to the tax. Similarly, if the property had generated rents, any net gain on sale would also be included in net investment income. The amount of the tax (if any) would depend on the calculation formula, above in

Q: My rental property generates a net loss each year. How will those losses be factored into the new tax? And what if I have net capital losses?

A: Net losses from rents and net capital losses reduce AGI. Thus, the losses themselves would not be subject to the tax. If, after losses, AGI still exceeds the thresholds, the tax would still apply if there were any interest or dividends income. Note that passive loss limitations will continue to apply to rental income and loss.

Q: All of my income is derived from ownership and operation of real estate investments. Will my rents and gains be subject to the new tax?

A: No. If the ownership and operation of real estate is your sole occupation, then those activities are what's called your "trade or business." Income derived from a trade or business is not subject to the new tax.