



Effects of new Medicare tax on real estate investors and their income

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Now that the Supreme Court has upheld the Patient Protection and Affordable Care Act, it is time to focus on the various revenue raising provisions in the act. The act includes two new taxes that will raise money for the Medicare Trust Fund that is part of the Social Security System. The revenue raised by these new taxes will be used to stabilize the Medicare Trust Fund.

The first tax is imposed on earned income in excess of \$200,000 for single taxpayers or \$250,000 for married taxpayers. The amount of earned income that exceeds these thresholds will be subject to a Medicare tax of .9%. This tax is in addition to the 1.45% Medicare tax that is imposed on all earned income. The concept of imposing a Medicare tax on earned income has been around for many years and, in effect, this new .9% tax is just a rate increase on high income taxpayers.

However, the second new tax is imposed on income items that were historically exempt from Medicare tax. Starting in 2013, Internal Revenue Code Section 1411 provides a Medicare tax of 3.8% on net investment income. This is the first time that investment income has been subjected to a separate Medicare tax. As you will see, this tax will impact real estate investors.

What we know about Medicare Tax on Investment Income

The Medicare tax equals 3.8% multiplied by the lower of the following

- * Net investment income; or
- * The excess of the modified adjusted gross income over the threshold amount.

The threshold amount is \$200,000 for single taxpayers and \$250,000 for married taxpayers. In addition to individual taxpayers, trusts and estates are subject to this tax. The threshold amount for trusts and estates will be approximately \$12,000.

What does all of this mean to the real estate investor? Generally, it means that net rental income from real estate investments will be subjected to this tax.

The statute includes in the definition of investment income interest, dividends, rents and income from passive activities. Investment income may be reduced by deductions attributable to any of these categories of income. Therefore, in determining net investment income rent is included. Since the statute allows related deductions to offset the income, the amount of net rent is included in net investment income.

For example, a married taxpayer who earns \$500,000 of salary and owns a rental property that generates \$30,000 of net rental income will be subject to the Medicare tax of 3.8% on the \$30,000 of net rental income, or \$1,140. Of course, if the rental property generated a net loss, then the net loss from the rental property will reduce the net investment income.

In addition to those investors who directly own the real estate investment, the new Medicare tax will also apply to those investors who own real estate through partnership or limited liability companies. For instance, a limited liability company passes net rental income of \$25,000 to one of its members.

This net rental income will be included in net investment income in computing the 3.8% Medicare Tax.

In addition, net rental income is included in modified adjusted gross income which is compared to the threshold amounts to determine if this Medicare tax applies. Generally, modified adjusted gross income means adjusted gross income as determined on the tax return increased by any foreign earned income exclusion.

For example, a married taxpayer earns \$240,000 and owns a rental property that generates \$20,000 of net rental income will be subject to the Medicare tax on \$10,000 of the net rental income. Not only did the net rental income create investment income, but it also put the taxpayer over the threshold amount. Taxpayer will have to pay \$380 of Medicare tax.

What we do not know
about the Medicare Tax
on Investment Income

There are a number of items that are unclear and need to be clarified by the Treasury Department. It is unclear how the passive activity rules interplay with the Medicare tax. A taxpayer who has net losses from rental real estate will most likely have the deductibility of the losses limited under the passive activity rules of Section 469. These losses will be carried forward and allowed as a deduction when the taxpayer has net rental income or disposes of the property.

It appears that losses subject to limitation under the passive activity rules will not be available to offset net investment income. Thus, a taxpayer that has net rental losses of \$30,000 that is not currently deductible due to the passive activity rules, will not be able to use these losses to offset the current year's net investment income.

It is also unclear how the net investment income Medicare tax will apply to real estate investors who qualify as real estate professionals. Generally, investors who spend substantial time in managing their real estate can qualify as a real estate professional and, therefore, the income and losses from these properties will not be subject to the passive activity rules. Generally, the real estate professional is treated as being in a trade or business of managing real estate.

It is clear that income or losses from a trade or business are not included in net investment income. Therefore, does the net rental income and losses earned by a real estate professional qualify as trade or business income and not subjected to the Medicare tax?

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