

## **MP&S TAX ALERT: IRS PROVIDES GUIDANCE ON ADDITIONAL 0.9% MEDICARE TAX**

On November 30, 2012, the IRS issued proposed regulations regarding the 0.9% Additional Hospital Insurance Tax on High-Income Taxpayers (commonly referred to as the Additional Medicare Tax), which takes effect January 1, 2013. The IRS also posted answers to frequently asked questions (FAQs) concerning the new tax on its website.

Individuals, employers and payroll service providers may rely on the proposed regulations until final regulations are published (which is expected in 2013).

### **Background**

Currently, under the Federal Insurance Contributions Act (FICA), wages are subject to a 2.9% Medicare tax — 1.45% paid by employers and 1.45% withheld from employees' wages. (A similar tax is imposed on railroad employers and employees under the Railroad Retirement Tax Act — please contact us for more information if relevant to your situation.)

Beginning in 2013, under the Patient Protection and Affordable Care Act of 2010, employees will be subject to the 0.9% Additional Medicare Tax on FICA wages and self-employment income to the extent that they exceed the following threshold amounts: \$250,000 for joint filers; \$125,000 for married taxpayers filing separately; and \$200,000 for individuals, heads of household and other filers.

Under the proposed regulations, employers are obligated to withhold the additional tax to the extent that an employee's wages exceed \$200,000 in a calendar year, without regard to an individual's filing status or wages paid by another employer. Also, unlike regular Medicare taxes, Additional Medicare Tax does not include a corresponding employer portion.

Please note that these proposed regulations and FAQs do not address the new 3.8% Medicare tax on net investment income of high-income taxpayers, which also takes effect beginning in 2013, and which is addressed by a different set of proposed regulations that were issued on the same day. (Those regulations will be the subject of a future Alert that will be issued in January.) However, the IRS noted in its FAQs that the net investment income tax does not apply to FICA wages or self-employment income.

### **Calculating the Tax**

Individuals liable for Additional Medicare Tax are required to report Additional Medicare Tax liability on their individual income tax returns (i.e., Form 1040). Individuals will also take credit for Additional Medicare Tax withheld by their employers on their individual tax returns. Any Additional Medicare Tax withheld by an employer will be applied against all taxes shown on an individual's income tax return, including any Additional Medicare Tax liability.

Calculating the tax is straightforward: Take the excess of the wages (or self-employment income) over the applicable threshold and then multiply that amount by 0.9%. For example, a husband and wife who each earn \$150,000 in FICA wages would be liable for Additional Medicare Taxes on \$50,000 (the excess of their combined \$300,000 in wages over the \$250,000 threshold for joint filers).

The proposed regulations also provide guidance on calculating the tax when an individual or married couple has both FICA wages and self-employment income.

The calculation of the tax is a three-step process:

1. Calculate Additional Medicare Tax on wages to the extent that they exceed the applicable threshold (without regard to withholding),

2. Reduce the applicable threshold by the total amount of Medicare wages received (but not below zero), and
3. Calculate Additional Medicare Tax on self-employment income to the extent it exceeds the reduced threshold.

Here's an example:

John and Heather are married and file jointly. John earns \$150,000 in FICA wages and Heather earns \$175,000 in self-employment income. John's wages don't exceed the \$250,000 threshold for joint filers, so the couple is not liable for Additional Medicare Tax on his wages. To calculate the tax on Heather's self-employment income, subtract John's \$150,000 from the \$250,000 threshold, for a reduced threshold of \$100,000. The couple is liable for Additional Medicare Tax on \$75,000 (Heather's \$175,000 in self-employment income minus the \$100,000 reduced threshold).

### **Withholding Issues**

As mentioned previously, the proposed regulations provide that an employer is required to withhold Additional Medicare Tax on wages in excess of \$200,000 in a calendar year, without regard to the employee's filing status or his or her income from other sources. This means that in some cases employers will be required to withhold the tax from wages paid to employees who are not liable for the tax — because, for example, their wages, together with those of their spouses, do not exceed the \$250,000 threshold for joint filers.

According to the FAQs, in this situation an employee cannot ask the employer to stop withholding the tax, but should instead claim a credit for the withheld taxes on his or her income tax return for the year.

It is also possible that no taxes will be withheld from employees who are liable for the additional tax. Suppose, for example, that a husband and wife file jointly and each has \$175,000 in FICA wages. Neither of their employers would be required to withhold Additional Medicare Tax, yet they would be liable for the tax to the extent their wages exceed the \$250,000 threshold. In this case, the tax would be \$900:  $0.9\% \times (\$350,000 - \$250,000)$ . Similarly, no Additional Medicare Tax would be withheld if an individual has two jobs and neither job pays wages in excess of the threshold.

Under the proposed regulations, employees who anticipate Additional Medicare Tax liability may not request that their employers withhold additional amounts specifically for the tax. They may, however, use Form W-4 to request additional income tax withholding sufficient to cover their liability for Additional Medicare Tax. To the extent this additional liability isn't covered by employer withholding, employees should use estimated tax payments to make up the shortfall and avoid interest and penalties.

If an employee's annual wages are expected to exceed \$200,000, the employer is not required to withhold Additional Medicare Tax from the beginning of the year. According to the FAQs, "An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of \$200,000 to an employee."

An employer that fails to meet its withholding, deposit, reporting and payment responsibilities is liable for Additional Medicare Tax, plus all applicable penalties. If the employee pays the tax, the employer is relieved of liability for the tax, but may still be subject to penalties.

### **Adjustments and Refund Claims**

The proposed regulations allow employers to make interest-free adjustments in the event of underpayments or overpayments of Additional Medicare Tax. Generally, this is done by filing the appropriate corrected return (for example, Form 941-X) and then either reimbursing overpaid amounts to the employee or collecting underpaid amounts from the employee's wages before the end of the year.

Underpayments may be adjusted only if the error occurs during the same year the underlying wages were paid (with certain exceptions, including underpayments attributable to administrative errors or IRS examinations). The employer is liable for the correct amount of tax, even if it is unable to deduct underpaid taxes from the employee's wages.

Overpayments may be adjusted if the employer ascertains the error in the year the wages were paid and reimburses the employee for overcollected amounts by the end of the year. If the employer is unable to reimburse the employee by year end, it should not make an adjustment. Instead, it should report the amount withheld on the employee's W-2 so the employee can obtain credit for the tax (and, if appropriate, a refund) on his or her individual income tax return.

The proposed regulations provide that an employer should only claim a refund of overpaid Additional Medicare Tax if it did not deduct or withhold the overpaid amounts from the employee's wages.

### **Get Ready – And MP&S Can Assist with Planning for the New Medicare Tax**

The Additional Medicare Tax will take effect January 1, 2013. To be ready, employers should be sure that their payroll procedures and systems are equipped to handle the new withholding requirements. High-income taxpayers should evaluate their liability for the tax and adjust their withholdings or estimated tax payments as needed. Your MP&S tax advisor can assist you with this, as well as with other issues involving the new Additional Medicare Tax.

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