

Proposed reliance regs explain post-2012 additional Medicare tax

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IRS has issued long-awaited guidance for employers and individuals on the new rule that applies an additional 0.9% Medicare tax to wages and compensation above a threshold amount received in tax years beginning after Dec. 31, 2012 and to self-employment income above a threshold amount received in tax years beginning after Dec. 31, 2012. The guidance on the new rule, which will cause complications for employers as well as employees and self-employed, comes in the form of proposed reliance regs and 47 questions and answers (Q&As).

Background. Under the 2010 Patient Protection and Affordable Care Act (PPACA, P.L. 111-148), effective for tax years beginning after 2012, there's an additional 0.9% Medicare (hospital insurance, or HI) tax on taxpayers (other than corporations, estates, or trusts) receiving wages with respect to employment in excess of \$200,000 (\$250,000 for married couples filing jointly and \$125,000 for married couples filing separately). (Code Sec. 3101(b)(2)) These amounts aren't indexed for inflation.

The tax is in addition to the regular Medicare rate of 1.45% on wages received by employees with respect to employment. The tax only applies to the employee portion of the Medicare tax. The employer Medicare tax rate remains at 1.45%, and the employer and employee Social Security tax remain at 6.2%.

Observation: Thus, beginning in 2013, the employer portion of FICA consists of two parts, and the employee portion consists of three parts, as follows:

For 2013, an employer pays a 7.65% FICA tax, consisting of:

1. 6.20% Social Security tax on the first \$113,700 of an employee's wages (maximum tax is \$7,049.40 [6.20% of \$113,700]), plus
2. 1.45% Medicare tax on the employee's total wages (no ceiling).

For 2013, an employee pays:

1. 6.20% Social Security tax on the first \$113,700 of wages (maximum tax is \$7,049.40 [6.20% of \$113,700]), plus
2. 1.45% Medicare tax on the first \$200,000 of wages (\$250,000 for joint returns; \$125,000 for married taxpayers filing a separate return), plus
3. 2.35% Medicare tax (regular 1.45% Medicare tax + 0.9% additional Medicare tax) on all wages in excess of \$200,000 (\$250,000 for joint returns; \$125,000 for married taxpayers filing a separate return). (Code Sec. 3101(b)(2))

The 0.9% additional Medicare tax applies only to employees, not employers. Employers must begin withholding the additional Medicare tax once an employee's wages exceed \$200,000, even if the employee may not ultimately be liable for the additional tax (e.g., employee earns \$210,000, his spouse earns \$25,000, and they file a joint return). (Code Sec. 3102(f)(1)) Any excess additional Medicare tax withheld will be credited against the total tax liability shown on the employee's income tax return.

Conversely, the 0.9% additional Medicare tax may be owed on the employee's income tax return where withholding is not collected for it (e.g., employee earns \$175,000 and her spouse earns \$150,000, or employee earns more than \$200,000 and employer fails to withhold). (Code Sec. 3102(f)(2)) If an employer fails to withhold the 0.9% additional Medicare tax, and the tax is subsequently paid by the employee, IRS will not collect the tax from the employer. However, the employer will remain subject to any applicable penalties or additions to tax for failure to withhold the 0.9% additional Medicare tax as required. (Code Sec. 3102(f)(3))

The Medicare tax on self-employment income for any tax year beginning after Dec. 31, 2012, is increased by an additional 0.9% of self-employment income which exceeds the same thresholds as apply for employees (see above). (Code Sec. 1401(b)(2)(A))

Thus, for 2013, the self-employment tax imposed on self-employed people has three tiers:

- 12.40% OASDI on the first \$113,700 of self-employment income, for a maximum tax of \$14,098.80 (12.40% of \$113,700); plus
- 2.90% Medicare tax on the first \$200,000 of self-employment income (\$250,000 of combined self-employment income on a joint return, \$125,000 on a separate return), (Code Sec. 1401(a), Code Sec. 1401(b)); plus
- 3.80% (2.90% regular Medicare tax + 0.9% additional Medicare tax) on all self-employment income in excess of \$200,000 (\$250,000 of combined self-employment income on a joint return, \$125,000 for married taxpayers filing a separate return). (Code Sec. 1401(b)(2))

The above \$250,000, \$125,000, and \$200,000 thresholds are reduced (but not below zero) by the amount of wages taken into account in determining the additional 0.9% HI tax on wages. (Code Sec. 1401(b)(2)(B))

Under Code Sec. 6654(m), the 0.9% additional Medicare tax is treated as a tax subject to estimated tax payment requirements. In the case of employees, the additional 0.9% Medicare tax is collected through withholding on FICA wages (or Railroad Retirement Tax Act (RRTA) compensation) in excess of \$200,000 in a calendar year. In addition, employees may request additional income tax withholding (ITW) on wages on Form W-4 and use this additional ITW to apply against taxes shown on their return, including any additional 0.9% Medicare tax liability. To the extent not withheld, the 0.9% additional Medicare tax must be included when making estimated tax payments. (Preamble to Prop Reg 11/30/2012)

Highlights of new guidance. The proposed regs and Q&As cover the additional 0.9% Medicare tax in great detail. Some of the more important aspects of the new guidance are as follows:

Withholding requirement. Employers must withhold the additional Medicare tax from wages in excess of \$200,000 regardless of filing status or other income. Thus, if the threshold is exceeded, the additional Medicare tax must be withheld even if the employee ultimately won't owe the tax because he and his spouse file a joint return and they won't meet the \$250,000 threshold for joint filers. (Prop Reg § 31.3102-4(a), Q&A 23) The additional withholding applies in the pay period in which the employer pays wages in excess of \$200,000 to an employee, and the employer need not notify the employee that additional withholding has commenced. (Q&As 25 and 28) Where a payment to an employee causes him to exceed the \$200,000 threshold, the additional withholding tax applies only to the portion of the payment that exceeds the threshold. For example, if an employee earns \$180,000 through Nov. 30, 2012, and then receives a bonus of \$50,000, her employer withholds the additional Medicare tax on \$30,000. (Q&A 29)

The employee cannot ask his employer to not withhold additional Medicare tax (e.g., he earns more than \$200,000, but his spouse has no earnings). In this situation, the employee will claim a credit for any withheld additional Medicare tax against the total tax liability shown on his individual income tax return (Form 1040). (Q&A 15).

An employee also can't ask the employer to withhold an extra amount specifically for the additional Medicare tax. However, the employee can request that the employer withhold an additional amount of income tax withholding on W-4, and that additional withholding will be applied against taxes owed on Form 1040, including any additional Medicare tax that's owed. (Q&A 10)

Complex rules apply to the relatively specialized situation of an employer that under- or over-withholds the additional Medicare tax. (Prop Reg § 31.6205-1(b)(4), Prop Reg § 31.6402(a)-2(b)(3), Q&As 43 to 47)

Corporate payers. When an employee is performing services for multiple subsidiaries of a company, and each subsidiary is an employer of the employee with regard to the services the employee performs for that subsidiary, wages paid by the payor on behalf of each subsidiary are combined for purposes of the additional Medicare tax only if the payor is a common paymaster. Wages are not combined for purposes of the \$200,000 withholding threshold if the payor is not a common paymaster. (Q&A 37)

When corporate acquisitions meet certain requirements (see, e.g., Rev Proc 2004-53, 2004-2 CB 320), wages paid by the predecessor are treated as if paid by the successor for purposes of applying the social security wage base and for applying the additional Medicare tax withholding threshold (that is, \$200,000 in a calendar year). (Q&A 36)

Types of payments subject to additional Medicare withholding. The proposed regs merely say that the additional Medicare tax applies to "wages" in excess of the \$250,000/\$125,000/\$200,000

thresholds (Prop Reg § 31.3101-2(b)(2)(i)), but the Q&As make it clear the tax applies to the following types of payments:

- **Fringe benefits.** The employer must withhold additional Medicare tax on total wages, including taxable noncash fringe benefits, in excess of \$200,000. The value of taxable noncash fringe benefits must be included in wages and the employer must withhold the applicable additional Medicare Tax and deposit the tax under the rules for employment tax withholding and deposits that apply to taxable noncash fringe benefits. (Q&A 31)
- **Group-term life.** The imputed cost of group-term life insurance coverage in excess of \$50,000 is subject to social security and Medicare taxes, and to the extent that, in combination with other wages, it exceeds \$200,000, it is also subject to additional Medicare tax withholding. When group-term life insurance over \$50,000 is provided to an employee (including retirees) after termination, the employee share of social security and Medicare taxes and additional Medicare tax on that period of coverage is paid by the former employee with his or her tax return and is not collected by the employer. (Q&A 33)
- **Nonqualified deferred compensation (NQDC).** Wages for purposes of withholding additional Medicare tax from NQDC are calculated in the same way as for withholding the existing Medicare tax from NQDC. Thus, if an employee has amounts deferred under a NQDC plan and the NQDC is taken into account as wages for FICA tax purposes under the special timing rule in Reg. § 31.3121(v)(2)-1(a)(2), 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. (Q&A 35)
- **Third-party sick pay.** Wages paid by an employer and by the third party need to be aggregated to determine whether the \$200,000 withholding threshold has been met. The same rules that currently assign responsibility for sick pay reporting and payment of Medicare tax based on which party is treated as the employer (i.e., the employer, the employer's agent, or a third party that is not the employer's agent) apply also to additional Medicare tax. (Q&A 34)
- **Tips.** To the extent that tips and other wages exceed \$200,000, an employer applies the same withholding rules for additional Medicare tax as it does currently for Medicare tax. An employer withholds additional Medicare tax on the employee's reported tips from wages it pays to the employee. A special rule applies where an employee does not receive enough wages for the employer to withhold all the taxes that the employee owes, including additional Medicare tax. (Q&A 32)

Estimated tax. A taxpayer who anticipates owing additional Medicare tax but won't satisfy the liability through withholding may need to make estimated tax payments, but there's no need to identify such payments as being for the additional Medicare tax. (Q&As 10, 11, 16)

Self-employed individuals who also have employment income. Under Prop Reg § 1.1401-1(d)(2), and Q&A 19, individuals with self-employment income subject to SECA tax and wages subject to FICA tax calculate their liabilities for the additional Medicare tax in three steps:

1. Calculate the additional Medicare tax on any wages in excess over the applicable threshold for the filing status (\$250,000/\$125,000/\$200,000), without regard to whether any tax was withheld.
2. Reduce the applicable threshold for the filing status by the total amount of Medicare wages received (but not below zero).
3. Calculate the additional Medicare tax on any self-employment income in excess of the reduced threshold.

Illustration : Charles, a single filer, has \$130,000 in wages and \$145,000 in self-employment income. Before calculating the additional Medicare tax on self-employment income, the \$200,000 threshold for single filers is reduced by Charles' \$130,000 in wages, resulting in a reduced self-employment income threshold of \$70,000. Charles has to pay additional Medicare tax on \$75,000 of self-employment income (\$145,000 in self-employment income minus the reduced threshold of \$70,000).

Illustration : Dan and Ellen are married and file jointly. Dan has \$150,000 in wages and Ellen has \$175,000 in self-employment income. Before calculating the additional Medicare tax on Ellen's self-employment income, the \$250,000 threshold for joint filers is reduced by Dan's \$150,000 in wages, resulting in a reduced self-employment income threshold of \$100,000. Dan and Ellen are liable to pay additional Medicare tax on \$75,000 of self-employment income (\$175,000 in self-employment income minus the reduced threshold of \$100,000).

PPACA did not provide a reduction in the self-employment income threshold amounts by the amount of any RRTA compensation taken into account in determining liability for additional Medicare tax. As a result, an individual who receives both RRTA compensation and self-employment income does not reduce the self-employment income threshold amounts by the amount of RRTA compensation taken into account in determining additional Medicare tax liability. (Prop Reg § 1.1401-1(d)(2))