The Internal Revenue Service (IRS) released guidance implementing three new federal taxes under the Patient Protection and Affordable Care Act (Affordable Care Act) beginning January 1, 2013:

- A proposed rule imposing an 0.9% additional Medicare tax on high-income earners;
- A proposed rule implementing a 3.8% net investment tax on certain investment income for high-income earners; and
- Final rules implementing a 2.3% excise tax on medical devices.

Although the rules on the additional Medicare tax and the net investment income tax are in proposed form, the IRS stated that taxpayers may rely on the proposed rules beginning January 1, 2013. Any changes made in the final rules will only apply after publication of the final rules. This Aon Hewitt bulletin describes the rules for each of the new taxes.

### Additional Medicare Tax on High-Income Earners

The Affordable Care Act imposes an additional Medicare tax on an individual’s wages that exceed $250,000 (for married taxpayers filing jointly), $125,000 (for married taxpayers filing separately), and $200,000 for all other taxpayers. The additional tax, which applies in tax years beginning after December 31, 2012, applies only to the employee portion of the Medicare tax and does not affect the portion of the Medicare tax paid by employers.

### Employer and Payroll Responsibilities

An employer is responsible for withholding the additional 0.9% Medicare tax from wages or compensation it pays to an employee in excess of $200,000 beginning January 1, 2013, without regard to the individual’s filing status or wages paid by another employer. Any additional withheld Medicare tax will be credited against an individual’s total tax liability shown on his or her individual income tax return.

An employer that fails to withhold the additional 0.9% Medicare tax is liable for the tax unless the employee actually pays the tax. If errors in withholding are discovered, they may be corrected through an interest-free adjustment provided in the proposed rule, but only in the same calendar year in which wages are paid. Further, an employer is subject to all other applicable penalties for failing to properly withhold the additional Medicare tax.

The additional 0.9% Medicare tax applies only to wages paid to an employee in excess of $200,000 in a calendar year. If an employee receives wages from an employer in excess of $200,000 and the wages include taxable noncash fringe benefits, the employer calculates wages for purposes of withholding the additional 0.9% Medicare tax in the same way that it calculates wages for withholding the existing Medicare tax—i.e., the value of the taxable noncash fringe benefits must be included in wages and the...
employer must withhold the applicable additional 0.9% Medicare tax and deposit the tax under the rules for employment tax withholding and deposits that apply to taxable noncash fringe benefits.

Similarly, the same rules regarding sick pay from a third party and the calculation of wages from a nonqualified deferred compensation plan apply in determining wages subject to the additional 0.9% Medicare tax.

Reliance on Proposed Rule

As stated above, although these proposed rules will not be finalized before the tax becomes applicable on January 1, 2013, taxpayers must comply with the law as of that date and may rely on these proposed rules. If any requirements change in the final rules, taxpayers will only be responsible for complying with the new requirements from the date the final rules are published.

Net Investment Income Tax

For a tax year beginning on or after January 1, 2013, the Affordable Care Act will impose a 3.8% net investment income tax on individuals, estates, and trusts with investment income above a certain threshold amount. The amount of the tax on individuals is equal to 3.8% of the lesser of:

- An individual’s net investment income for such taxable year; or
- The excess, if any, of 1) the individual’s modified adjusted gross income for such taxable year, over 2) the threshold amount.

Individuals will owe the tax if they have net investment income and also have modified adjusted gross income above $250,000 (if married filing jointly), $125,000 (if married filing separately), and $200,000 (if single). These threshold amounts are not indexed for inflation. For example:

**Facts**—Taxpayer, a single filer, has $180,000 of wages. Taxpayer also received $90,000 from a passive partnership interest, which is considered net investment income. Taxpayer’s modified adjusted gross income is $270,000. Taxpayer’s modified adjusted gross income exceeds the threshold of $200,000 for single taxpayers by $70,000. Taxpayer's net investment income is $90,000.

**Result**—The net investment income tax is based on the lesser of $70,000 (the amount that taxpayer’s modified adjusted gross income exceeds the $200,000 threshold) or $90,000 (taxpayer’s net investment income). Taxpayer owes net investment income tax of $2,660 ($70,000 x 3.8%).

What Is Investment Income?

Under the proposed rule, in general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer. Net investment income also includes any interest, dividends, and capital gains of an individual’s children that are included on an individual’s income tax return.
Examples of gains taken into account in calculating net investment income (to the extent not otherwise offset by capital losses) include gains from the sale of stocks, bonds, and mutual funds; capital gain distributions from mutual funds; and gains from the sale of investment real estate (including gains from the sale of a second home that is not a primary residence).

**What Is Not Investment Income?**

Income that is not considered net investment income includes wages, unemployment compensation, operating income from a nonpassive business, Social Security benefits, alimony, tax-exempt interest, self-employment income, and distributions from certain qualified plans (401(a), 403(a), 403(b), 408, 408A, or 457(b)).

**Estates and Trusts Subject to Net Investment Income Tax**

Estates and trusts will be subject to the net investment income tax if they have undistributed net investment income and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year (for tax year 2012, this threshold amount is $11,650).

**Trusts Not Subject to the Net Investment Income Tax**

Trusts that are not subject to the net investment income tax include: trusts that are exempt from income taxes, such as charitable trusts and qualified retirement plan trusts exempt from tax under Code Section 501; a trust in which all of the unexpired interests are devoted to trusts and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; trusts that are classified as “grantor trusts”; and trusts that are not classified as “trusts” for federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).

**Applicability to U.S. Territories**

According to the proposed rule, the net investment income tax will apply to individuals living in American Samoa and Puerto Rico because they are still subject to U.S. federal income tax laws. The only exception is if individuals residing in these territories are nonresident aliens with respect to the U.S.

Guam, the Northern Mariana Islands, and the U.S. Virgin Islands have a tax code that is generally identical to the U.S. tax code and therefore, the net investment income tax does not apply to individuals living in these territories because they have no income tax obligation to the U.S. provided that they comply with the tax laws of the relevant territory.

**Reliance on Proposed Rule**

Similar to the additional Medicare tax, taxpayers may rely on the proposed rule for determining the net investment income tax during 2013.
Advanced Medical Device Tax

The IRS issued final regulations to implement a new 2.3% excise tax to be imposed on manufacturers and importers on the sales of certain advanced medical devices beginning January 1, 2013. Also on December 5, 2012, the IRS released Notice 2012-77 to provide transitional relief during the first three quarters of 2013 regarding the determination of sale price and other issues related to the tax.

Industry commentators note that the tax applies mostly to devices used and implanted by medical professionals, ranging from pacemakers and knee replacements to surgical sutures and tongue depressors. Commentators have raised concerns that manufacturers will pass through the cost of the tax to purchasers of medical devices, such as providers and health care plans.

The final regulations define a “taxable medical device” as a device that is listed as a device with the Food and Drug Administration (FDA). If a device is not listed as a device with the FDA but the FDA determines that the device should have been listed as a device, the device will be deemed to be listed as a device with the FDA as of the date the FDA notifies the manufacturer or importer in writing that corrective action with respect to listing is required.

The new tax does not apply to the sale of eyeglasses, contact lenses, hearing aids, and any other devices that are of a type generally purchased by the general public at retail for individual use (the retail exemption). A facts and circumstances approach is used to evaluate whether a type of device qualifies for the retail exemption. The final rule suggests factors to consider in the evaluation and is a non-exhaustive list. However, the final rule provides that several categories of medical devices qualify for the retail exemption safe harbor, including: devices in the FDA’s online in-vitro diagnostics (IVD) Home Use Lab Tests (Over-the-Counter Tests) database; devices that the FDA describes as “over the counter” in certain official FDA classification or product code headings or descriptors; and a number of devices that qualify as durable medical equipment, prosthetics, orthotics, or supplies for which payment is available on a purchase basis under the Medicare Part B payment rules.

Payment of the tax is made quarterly, and the first quarterly return for the medical device excise tax is due April 30, 2013, for the months of January, February, and March 2013. Manufacturers and importers of taxable medical devices also must make semimonthly deposits of tax. The first semimonthly deposit for the medical device excise tax, which covers the first 15 days of January, is due January 29, 2013.

Next Steps

Comments on the proposed rules regarding the additional Medicare tax and the net investment income tax are due by March 5, 2013. Comments on IRS Notice 2012-77 are due March 29, 2013.

More Information

The additional Medicare tax proposed rule is available at: [http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29237.pdf](http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29237.pdf)

The net investment tax proposed rule is available at: http://www.gpo.gov/fdsys/pkg/FR-2012-12-05/pdf/2012-29238.pdf

The IRS’s net investment tax FAQs are available at: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs

The medical device excise tax final rule is available at: http://www.gpo.gov/fdsys/pkg/FR-2012-12-07/pdf/2012-29628.pdf


The IRS press release on the medical device excise tax is available at: http://www.irs.gov/uac/Newsroom/Medical-Device-Excise-Tax
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