TAX REPORT | By Laura Saunders

About That Investment Tax...

The word is out: Two new taxes on the affluent and wealthy will take effect as scheduled next year as a result of the Supreme Court's decision upholding the health-care overhaul. One is a new 3.8% tax on net investment income, and the other is a 0.9% increase in the Medicare tax on wages and self-employment income.

Both levies apply to joint filers with adjusted gross incomes above $250,000 ($200,000 for singles). A recent Wall Street Journal article discussed the basics (see "Get Ready for the New Investment Tax," June 30), but many questions remain. Here are some answers.

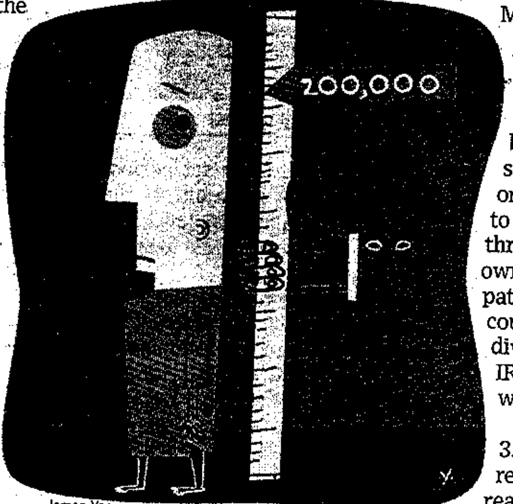
◆ **Inflation indexing.** Unlike many other tax provisions, including the estate-tax exemption, the $250,000/$200,000 threshold for these two new taxes isn't adjusted for inflation, according to Congress's Joint Committee on Taxation. This means lawmakers likely will face a dilemma—either pass an expensive "patch" every year or two or let the taxes apply to thousands of additional taxpayers because of inflation.

◆ **Effect on Americans abroad.** U.S. taxpayers living abroad are asking whether the new taxes apply to them, especially if they use a foreign health-care system. There isn't any Internal Revenue Service guidance yet, but some experts—including Susan Brown Otto, a CPA in Jeffersonville, N.Y., who specializes in international taxes—expect the 3.8% tax will apply to many expatriates, while some might be exempted from the 0.9% tax on pay.

Here's why: Currently 24 countries have agreements with the U.S. that prevent or alleviate double U.S. and foreign Social Security taxes. (For a list and details, see www.socialsecurity.gov/international.) These agreements might ease the burden of the extra 0.9% Medicare tax on pay for some, Ms. Otto says.

The 3.8% tax on investment income, however, isn't covered by the Social Security agreements, so it may be hard to avoid. In addition, there is a provision in the law requiring U.S. citizens living abroad to "add back" their foreign earned-income exclusion of about $95,000 before figuring the tax, which will boost their adjusted gross income.

◆ **AMT interaction.** There isn't a direct interaction between the alternative minimum tax, which limits the use of tax benefits, and the two new taxes. Both new levies are calculated using adjusted gross income, the number at the bottom of the front page of the 1040 form.



James Yang

◆ **Executive compensation.** For employees above the $250,000/$200,000 income threshold, the 0.9% tax applies to any gain on "nonqualified" stock options—the vast majority of those now issued—when the options are exercised. It also applies to restricted stock when the stock vests.

The tax treatment of dividends paid on restricted stock depends on whether the worker has made an "83(b) election" to accelerate income taxes on the shares. If so, the dividends will be subject to the 3.8% tax, says Eddie Adkins, a benefits specialist at Grant Thornton. If not, the dividends will be subject to the 0.9% tax, assuming the employee is above the income threshold.

Taxable fringe benefits—such as personal use of a company car or airplane—will be subject to the 0.9% tax for employees above the income threshold.

◆ **Gray areas.** Because the IRS hasn't issued guidance interpreting the taxes, gray areas remain. Some taxpayers have asked whether the income from investments such as master limited partnerships and real-estate investment trusts will be subject to the 3.8% tax, because they weren't named in the original law. The answer is almost certainly yes, says Chris Hesse, a CPA at CliftonLarsonAllen in Minneapolis, unless the payment qualifies as a return of capital.

However, certain payments from Subchapter S businesses might not be subject to either the 0.9% or the 3.8% tax, according to Mr. Hesse. This "pass-through income" goes to owners who actively participate in the business; it counts neither as wages nor dividends, a loophole the IRS finds difficult to close without congressional help.

It also is unclear if the 3.8% tax will apply to rental income received by real estate professionals who participate in the business and are over the income threshold. "The professional may qualify to make an election that would bypass the two taxes," Mr. Hesse says.

◆ **Chance of repeal.** Look to the outcome of the November elections, say experts. A majority of current House members oppose the health-care overhaul, so much depends on the Senate's makeup. Under some scenarios, repeal would require only a majority in the Senate.

When lawmakers enacted the two new taxes in 2010, revenue estimators projected they would bring in some $210 billion before the end of 2019. In theory, lawmakers are supposed to replace forgone revenue, says Roberton Williams of the Tax Policy Center in Washington, but in practice they don't always make up the loss.

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