# The 3.8% Medicare Contribution Tax on Unearned Income, Including Real Estate Transactions

**name redacted**
Analyst in Economics

May 18, 2012

**Congressional Research Service**
7-....
www.crs.gov
R41413

**CRS Report for Congress**
*Prepared for Members and Committees of Congress*

# Overview

The Health Care and Education Reconciliation Act of 2010 (HCERA, P.L. 111-152) contains a provision that will subject certain individuals to a 3.8% "unearned income Medicare contribution" tax beginning in 2013.[1] The tax has been labeled by some as a "home sales tax" or "real estate tax." The tax, however, is not exclusively limited to real estate transactions. Additionally, contrary to some reports, the tax does not apply to all real estate transactions. Some taxpayers that dispose of real estate may be exempt from the tax either because of income limitations or because of an exclusion provided for primary residence home sales. Other taxpayers may be subject to the tax even if they do not dispose of real estate. There have been proposals in the 112th Congress to repeal the tax, including H.R. 1549 and S. 1738. This report provides a summary of the tax and generalized examples of its application.[2]

# Description

The tax will apply to single taxpayers with a modified adjusted gross income (MAGI) in excess of $200,000 and married taxpayers with an MAGI in excess of $250,000.[3] MAGI includes wages, salaries, tips, and other compensation, dividend and interest income, business and farm income, realized capital gains, and income from a variety of other passive activities and certain foreign earned income. Taxpayers with a MAGI below these thresholds will not be subject to the 3.8% tax. For those who must pay the tax, the amount of tax owed will be equal to 3.8% multiplied by the lesser of (1) net investment income or (2) the amount by which their MAGI exceeds the above $200,000/$250,000 thresholds. Mathematically, the tax is:

$$Tax = 3.8\% \times \left[ Lesser\ of \left( MAGI - \$200{,}000 / \$250{,}000,\ or\ Net\ Investment\ Income \right) \right]$$

Home sales can trigger the tax in one of two ways. First, a home sale may result in a capital gain that increases net investment income. Net investment income includes interest, dividends, annuities, royalties, certain rents, and certain other passive business income. Net investment income also includes the amount of capital gain on a home sale that exceeds the amount that can be excluded from taxation. Currently, when taxpayers sell their principal residences, they may exclude from taxation up to $250,000 in capital gain if single, and $500,000 in capital gain if married.[4] If taxpayers sell a second home (vacation home, rental property, etc.), they must pay taxes on the entire capital gain.

[1] The tax also applies to estates and trusts, however, the application of the tax to these entities is different from how the tax applies to individuals. For a summary of how the tax affects estates and trusts see, U.S. Congress, Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," As Amended, in Combination with the "Patient Protection and Affordable Care Act"*, committee print, 111th Cong., March 21, 2010, JCX-18-10, pp. 134-136..

[2] For an overview of other health care reform-related revenue provisions see CRS Report R41128, *Health-Related Revenue Provisions in the Patient Protection and Affordable Care Act (ACA)*, by (name redacted).

[3] For a married taxpayer filing a separate return the income threshold is $125,000.

[4] CRS Report RL32978, *The Exclusion of Capital Gains for Owner-Occupied Housing*, by (name redacted) and (name redacted).

Second, a home sale may result in a capital gain that increases a taxpayer's MAGI. As mentioned above, the components of MAGI include wages, salaries, tips, and other compensation, dividend and interest income, business and farm income, realized capital gains, and income from a variety of other passive activities and certain foreign earned income. The realized capital gains component includes certain capital gains from home sales, depending on the type of home—principal residence or non-principal residence. There exists an exclusion on the capital gains resulting from the sale of a principal residence of $250,000 for single taxpayers and $500,000 for married taxpayers. Only the capital gain above these thresholds is included in MAGI. The entire capital gain from any other home sale is included in MAGI.

The parameters described above imply that the only time a home sale may be subject to the tax is if (1) the taxpayer's MAGI exceeds the $200,000/$250,000 threshold, and (2) the taxpayer engages in the sale of a principal residence resulting in a capital gain greater than $250,000 (if single) or $500,000 (if married), and/or engages in the sale of a non-principal residence that results in a capital gain.

# Examples

A few examples may help to clarify how home sales can trigger the new tax. The examples are intended to demonstrate the important features of the tax. Whether a particular taxpayer will be subject to the tax will depend on all facts and circumstances of their case. The first five examples assume that the only component of net investment income is the capital gain from a home sale. Recall that the capital gains exclusion for the sale of a principal residence is $250,000 for single taxpayers and $500,000 for married taxpayers. To demonstrate a scenario in which a taxpayer may be subject to the tax even though there is no home sale, the sixth example allows for net investment income other than a capital gain. The examples assume no tax credits, deductions, or other tax benefits are realized.

## Example 1

Consider a couple who earn a combined salary of $100,000 a year. They sell their principal residence for $400,000, and net a capital gain of $140,000.[5] Their MAGI in the year of the sale is therefore $100,000 (salary plus capital gain above $500,000 exclusion). Because their MAGI is less than the $250,000 threshold, they do not pay the unearned income Medicare tax. Notice, that because this household's MAGI is less than the income threshold it does not matter if the home they sell is their principal residence or a second home.[6] The distinction between principal and non-principal residences only matters if recognition of the full capital gain would cause the taxpayer's MAGI to exceed the specified income threshold.

[5] In this example, the basis of the couple's principal residence is $260,000. The excess of the sales price over the basis is the capital gain of $140,000.

[6] The household's MAGI in the case of a non-principal residence sale would be $240,000 - $100,000 plus $140,000.

## Example 2

Consider a couple who earn a combined salary of $100,000 a year. They sell their principal residence for $700,000, and net a gain of $640,000. Their MAGI in the year of the sale is therefore $240,000 (salary plus $140,000 gain above $500,000 exclusion). Because this couple's MAGI is less than the $250,000 threshold, they do not pay the unearned income Medicare tax. This example illustrates that even if a taxpayer realizes a gain that is more than the exclusion on principal residences, they may not be subject to the tax.

## Example 3

Consider a couple who earn a combined salary of $260,000 a year. They sell their principal residence for $1.2 million, and net a gain of $700,000. Their MAGI in the year of the sale is therefore $460,000 (salary plus $200,000 gain above $500,000 exclusion). Because this couple's MAGI exceeds the $250,000 threshold, they will have to pay the unearned income Medicare tax. The tax will be applied to the lesser of (1) net investment income or (2) the amount by which their MAGI exceeds the $250,000 threshold. Therefore, to determine to what amount the 3.8% tax should be applied to, the two figures must be compared:

- Amount MAGI exceeds income threshold: $460,000-$250,000 = $210,000
- Net investment income (capital gain above capital gain exclusion): $700,000-$500,000 = $200,000

$$Tax = 3.8\% \times \left[ Lesser\ of\ \$210{,}000\ or\ \$200{,}000 \right] = 3.8\% \times \$200{,}000 = \$7{,}600$$

## Example 4

Consider a couple who earn a combined salary of $260,000 a year. They do not engage in any transactions involving the sale of real estate. Although their MAGI exceeds the $250,000 threshold, they will not be subject to the unearned income Medicare tax since the tax is applied to the lesser of (1) net investment income or (2) the amount by which their MAGI exceeds the $250,000 threshold. Since their net investment income is zero, so too is their tax.

## Example 5

Consider a couple who earn a combined salary of $2 million a year. They sell their principal residence for $1.2 million, and net a gain of $700,000. Their MAGI in the year of the sale is therefore $2.2 million (salary plus $200,000 gain above $500,000 exclusion). Because this couple's MAGI exceeds the $250,000 threshold, they will have to pay the unearned income Medicare tax. The tax will be applied to the lesser of (1) net investment income or (2) the amount by which their MAGI exceeds the $250,000 threshold. Therefore, to determine to what amount the 3.8% tax should be applied to, the two figures must be compared:

- Amount MAGI exceeds income threshold: $2.2 million – $250,000 = $1.95 million

- Net investment income (capital gain above capital gain exclusion): $700,000-$500,000 = $200,000

$$Tax = 3.8\% \times \left[ Lesser\ of\ \$1.95\ million\ or\ \$200{,}000 \right] = 3.8\% \times \$200{,}000 = \$7{,}600$$

## Example 6

Consider a couple who earn a combined salary of $2 million a year. They sell their vacation home for $1.2 million, and net a gain of $700,000. There is no exclusion for non-principal residence home sales. Their MAGI in the year of the home sale is therefore $2.7 million. Because this couple's MAGI exceeds the $250,000 threshold, they will have to pay the unearned income Medicare tax. The tax will be applied to the lesser of (1) net investment income or (2) the amount by which their MAGI exceeds the $250,000 threshold. Therefore, to determine to what amount the 3.8% tax should be applied to, the two figures must be compared:

- Amount MAGI exceeds income threshold: $2.7 million-$250,000 = $2.45 million
- Net investment income (capital gain above capital gain exclusion): $700,000-$0 = $700,000

$$Tax = 3.8\% \times \left[ Lesser\ of\ \$2.45\ million\ or\ \$700{,}000 \right] = 3.8\% \times \$700{,}000 = \$26{,}600$$

## Example 7

Consider a couple who earn a combined salary of $260,000 a year. They do not engage in any transactions involving the sale of real estate. They do, however, have $50,000 in dividend and interest income. Their MAGI is therefore $310,000, and their net investment income is $50,000. Because this couple's MAGI exceeds the $250,000 threshold, they will have to pay the unearned income Medicare tax. The tax will be applied to the lesser of (1) net investment income or (2) the amount by which their MAGI exceeds the $250,000 threshold. Therefore, to determine to what amount the 3.8% tax should be applied to, the two figures must be compared:

- Amount MAGI exceeds income threshold: $310,000 – $250,000 = $60,000
- Net investment income: $50,000

$$Tax = 3.8\% \times \left[ Lesser\ of\ \$60{,}000\ or\ \$50{,}000 \right] = 3.8\% \times \$50{,}000 = \$1{,}900$$

## Author Contact Information

(name redacted)
Analyst in Economics
/redacted/@crs.loc.gov, 7-....