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## **Assisting Family Lawyers With Navigating the 2013 Tax Changes Under the Patient Protection Care Act (PPACA) and the Health Care and Education Reconciliation ACT (HCERA)**

On June 28, 2012, the United States Supreme Court issued a 5 to 4 decision on the Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA). The following tax-related provisions were preserved by this decision and impact support and property division calculations for divorcing individuals:

- Additional Medicare tax on earned income of higher income individuals
- Medicare tax on unearned income/net investment income
- Medicare tax on passive net investment income including some real estate income
- Disclosure of cost of employer-provided coverage on Forms W-2 for informational purposes
- Other changes that include tax on distributions from health savings accounts (HSAs)

Each of these items will be addressed below. The examples which follow explain the fundamentals of these tax increases on calculating support and formulating the division of property.

### **ADDITIONAL MEDICARE TAX ON EARNED INCOME**

For tax years beginning before December 31, 2012, the Medicare tax consisted of employees and employers each paying a flat 1.45% on earnings and 2.9% on net income (earnings) from self-employment. Starting with tax years beginning after December 31, 2012, there is an additional Medicare tax of 0.9% on earned income to be borne only by the employee. The employee's and self-employed individual's share of the Medicare tax is now 2.35% if earned income is in excess of the thresholds below. The new tax is applicable to only the earned income currently subject to Medicare tax that is in excess of the applicable threshold for an individual's filing status (together with that of his or her spouse if filing a joint return). Earned income includes, but is not limited to, such items as wages, group term life insurance, third party sick pay, and nonqualified deferred compensation. The filing status and income thresholds are as follows:

<b><u>Tax Filing Status</u></b>	<b><u>Income Threshold<sup>1</sup></u></b>
Single	\$200,000
Head of household	\$200,000
Married filing jointly	\$250,000 (combined)
Married filing separately	\$125,000
Qualifying widow(er)	\$200,000

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<sup>1</sup> For purposes of calculating the additional Medicare tax, modified adjusted gross income (MAGI) is used (which in many cases is the same as adjusted gross income). This amount is the taxpayer's adjusted gross income plus any foreign income excluded from income under IRC Section 911(a)(1).

An employer is required to withhold the additional tax if the individual meets the threshold through earnings, but has no obligation for the withholding if the threshold is met as a married couple or based on additional earnings from elsewhere.

As with any other employment tax the additional Medicare tax must be deducted in the calculation net income available for support. One new challenge is allocating between the spouses the additional Medicare tax when the combined earned income exceeds the threshold yet each do not meet the \$250,000 from their own earnings.

## **MEDICARE TAX ON UNEARNED/NET INVESTMENT INCOME (NII)**

A significant change to the Medicare tax (which historically was exclusively a payroll tax) is that it now applies to net investment and unearned income over the above income threshold amounts. A new 3.8% additional tax on unearned income<sup>2</sup> is comprised of the employer (1.45%), employee (1.45%), and high income surcharge (0.9%). The tax applies to the lesser of investment income or the excess of Modified Adjusted Gross Income (MAGI) over the income thresholds shown above.

Investment income includes interest, dividends, rents (less expenses), capital gains (net of capital losses, but not to below zero), royalties, and passthrough income from a passive businesses,<sup>3</sup> and is net of any deductions properly allocable to that income. However, although MAGI and taxable income are reduced by net operating loss (NOL) carryforwards, net investment income cannot be reduce by NOLs. The following income items are exempt from the Medicare tax: tax-exempt municipal bond interest, exemption of excluded gain from the sale of a principal residence, veteran's benefits, rentals designated by the Code as nonpassive if they are grouped with a business<sup>4</sup>, and distributions from an IRA, 403(b), 401(k), 457, pension, profit sharing stock bonus, or qualified annuity plan. Although IRAs and qualified plans are expressly excluded from Medicare tax, they are still included in and increase MAGI. Further, all active<sup>5</sup> income above the thresholds would continue to be exempt from this Medicare tax. This tax, although calculated differently, also affects trust and estate income.

If tax considerations are to be measured when dividing assets the new Medicare, federal, and state income taxes must be calculated for net capital gain assets (15% or 20% current federal tax rate, any state tax rate, plus a 3.8% Medicare tax, if applicable). In addition, as mentioned above, if interest and dividends are reserved for equitable distribution, the Medicare and income tax due on this income should be taken into account. Moreover, if credits are awarded

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<sup>2</sup> Internal Revenue Code (IRC) Section 1411.

<sup>3</sup> Passive business relates to a passive activity under IRC Section 469 or a trade or business of trading in financial instruments or commodities as defined under IRC Section 475(e)(2).

<sup>4</sup>Regulation 1.469-4.

<sup>5</sup> IRC Section 469 provides that active participation under material participation rules generally means spending more than 500 hours in an activity. See passive versus nonpassive participation in real estate discussion section below.

to the party that paid tax on marital interest, dividends, and capital gains, the Medicare tax must also now be considered. Finally in calculating net income available for support the Medicare tax on non-marital investment income is deducted from income just like any other federal or state income tax.

## **EXAMPLES OF MEDICARE TAX CALCULATIONS ON EARNED AND INVESTMENT INCOME**

The following provides two examples of the Medicare tax on earned and investment income and how this impacts net income available for support and property division:

1. If a married couple is separated but chooses to file a joint return with \$200,000 in earned income and \$350,000 in capital gains, dividends, and rentals they would pay
  - Federal income tax on all of their income (\$550,000)
  - The employee portion of the Medicare tax of 1.45% on earned income (\$200,000)
  - 3.8% Medicare tax on \$300,000 of unearned income
  - Under this example, the first \$50,000 of investment income would be exempt from the Medicare tax (lesser of investment income of \$350,000 or excess of income over \$250,000, or \$300,000).
  - Therefore, the Medicare tax would be 1.45% of \$200,000 plus 3.8% of \$300,000 = \$2,900 + \$11,400 = \$14,300. Under the prior law only the \$2,900 would have been paid.
  - The Medicare tax of \$2,900 is to be considered in arriving at net income available for support, however the \$11,400 tax on investment income may or may not be included in the net income available for support calculation depending on whether the investment income is treated as income for support or division of property. Further, there may to be an allocation between the two parties based on which party generated the income.
  
2. If a married couple is separated but chooses to file a joint return with \$325,000 in earned income and \$10,000 in capital gains, dividends, and rentals they would pay
  - Federal income tax on all of their income (\$335,000)
  - The employee portion of Medicare tax at 1.45% on earned income (\$325,000)
  - 0.9% Medicare tax on \$75,000 (\$325,000 earned income - \$250,000 threshold)
  - 3.8% Medicare tax on \$10,000 (the lesser of net investment income or the total income over the threshold).
  - Therefore, the Medicare tax would be 1.45% on \$325,000 plus 0.9% of \$75,000 plus 3.8% of \$10,000 = \$4,712 + \$675 + \$380 = \$5,767. Under the prior rules only the \$4,712 would have been paid.
  - The Medicare tax of \$5,387 is to be considered in arriving at net income available for support, however the \$380 from investment income may or may not be included depending on whether the investment income is treated as income available for support or division of property.

## **MEDICARE TAX ON INCOME FROM REAL ESTATE (PASSIVE VERSUS NONPASSIVE)**

By definition, income from real estate is treated under the Internal Revenue code as passive income<sup>6</sup>. As with investment income, this would subject the net income from real estate to the additional Medicare tax. However the IRS does recognize that there are individuals for whom real estate income may not be a passive activity.

There are standards to recast real estate income as active allowing relief from the passive activity loss (PAL) rules. The tests are based on the amount of hours spent on an individual's real estate activities and the materiality of that participation in the activity. If the passive activity rules were applied to most real estate investment entities individually, most real estate professionals would not meet this test as their efforts are generally spread among many separate real estate investments such as those owned by separate limited partnerships. The regulations under the tax code allow a real estate professional to group similar real estate investments together to treat them as one activity and to then apply the material participation standards to that combined group of investments. In order to qualify as a real estate professional, the individual must devote at least 750 hours each year to this group of real estate activities. Generally the casual investor in real estate will be subject to the new Medicare tax as they do not meet the 750 hours test, while an individual who devotes their full time activity in the real estate trade or business will not.

If real estate development and ownership is the family business and these assets are divided, one spouse may no longer qualify as a real estate professional after the divorce is final. This will subject that spouse's net real estate income to the 3.8% Medicare tax.

## **EXAMPLES OF MEDICARE TAX ON REAL ESTATE**

### **1. Capital Gain on Sale of a Principal Residence**

A married couple is separated and chooses to file a joint return. They have earnings of \$300,000 (\$150,000) each. The parties sold their principal residence and realized a gain of \$550,000.

- Their taxable gain is \$50,000 (\$550,000 less \$500,000 exemption on sale of principal residence), so their AGI is \$350,000.
- The parties will pay federal income taxes at ordinary rates on the \$300,000 of earned income and capital gains rates on \$50,000.
- They will pay additional Medicare tax of 0.9% of \$50,000 (\$300,000-\$250,000) and 3.8% of \$50,000 (the lesser of the investment net income (\$50,000) or the total income over the threshold (\$100,000)).
- Therefore, the Medicare Tax would be \$450 (0.9% x \$50,000) plus \$1,900 (3.8% x \$50,000) = \$2,350. In this case since each party earned the same income, the tax

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<sup>6</sup> IRC Section 469.

should be divided equally between them. The \$450 would be considered in calculating income available for support and the \$1,900 could be reserved for equitable distribution.

## 2. Capital Gain on Sale of Inherited Investment Property

A married couple that is separated chooses to file jointly. The Husband inherited an investment property which appreciated from date of inheritance to the date of separation by \$850,000. Further during this time, Husband depreciated the property by \$350,000

- On disposition there is a gain of \$1,200,000 consists of capital gain of \$850,000 and depreciation recapture of \$350,000.
- Before 2013, no Medicare taxes would have been paid in this scenario.
- Now Medicare tax on the \$950,000 (\$1,200,000-\$250,000 threshold) is due at a rate of 3.8% which equals \$36,100.
- This tax must be evaluated in comparing assets to be distributed. In some states the increase in value of the inherited property during marriage is marital and therefore a portion of the Medicare Tax should be allocated to the marital and non-marital portion.

## **MEDICARE TAX ON TRUSTS AND ESTATES**

Trusts and estates will be subject to the tax on Net Investment Income in the same manner as individuals just at lower tax exemption levels. As such, the definition of passive investment income within the trust becomes vitally important. A trust cannot be active in an investment unless the activity is coming from some other individual. The IRS is currently refining their position in regards to what creates non-passive income within a trust.

The IRS's position (which has followed the legislative history) indicated that a trust will materially participate in an activity only if the fiduciary so participates. The IRS has applied the same standards of "regular, continuous, and substantial participation" as defined in IRC Section 469 and stated that the trustee's activity in their role as trustee must be in the trust's business activity.

While there have been past court cases that have expanded on the requirements to create non-passive income within a trust, this area of the law is currently developing and as such is subject to substantial uncertainty at this time. Every tax payer's situation is unique and if the taxpayer feels they would benefit from a different reading of the case law, they should consult with a tax attorney who can provide specific guidance.

## **OTHER TAX ISSUES AFFECTING FAMILY LAW CALCULATIONS**

For purposes of preparing net income available for support calculations, the employer match of health insurance (not including dental) may be easier to identify starting in 2012. It will be required that the employee portion and the employer match be reported by employers on Form W-2 *Wage and Tax Statement* in box 12 with the code DD to identify the amount. Any employer that had less than 250 employees in 2011 is exempt from having to include this on 2012 W-2s. Finally, there is increase to the penalty on distributions from health savings accounts (HSAs) and certain other arrangements if the funds are not used for qualified expenses. The funds distributed for nonqualified expense are included in gross income and the additional tax has increased from 10% to 20%.

## **SUMMARY**

The Medicare tax changes need to be considered when calculating any federal tax calculations for divorce planning, negotiating, support calculations, property division and post-divorce planning. For high net-worth individuals this could have a significant impact on support payments and net marital estate value.