



Income tax

Overview of the Medicare surtax

Beginning in 2013, a 3.8% Medicare surtax* has been imposed on certain passive investment income of individuals, trusts and estates based on a mathematical formula. For taxpayers to be able to reduce the impact of the tax, they must first understand to which income it applies and how the tax is calculated.

Medicare surtax and individuals

As with most tax concepts, there are some new terms to define. For individuals, the amount subject to the tax is the lesser of (1) net investment income (NII) or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount. Each of these terms is defined below.

- **Net investment income** (NII) is investment income reduced by any allocable deductions. For purposes of the surtax, investment income includes:
 - Dividends
 - Rents
 - Interest
 - Capital gains
 - Royalties
 - Passive activity income (net of profits and losses)

Note that self-employment income, income from an active trade or business, IRA or qualified plan distributions, and distributions from a charitable remainder trust are specifically excluded from the definition of net investment income.

- **Modified adjusted gross income** (MAGI) is generally total taxable income and does not include tax-exempt income such as interest on tax-exempt bonds, excluded gain on the sale of the principal residence or veteran's benefits. For most taxpayers, this is the same amount reported at the bottom of page one of Form 1040 (AGI). U.S. citizens or residents who live abroad will need to add in the net amount excluded as foreign earned income under IRC section 911 (a) (1).

Required minimum distributions from a traditional IRA or 401(k) plan and income recognized on a Roth IRA conversion are included in MAGI, but nontaxable distributions from a Roth IRA are not.

The threshold amounts for when the Medicare surtax applies for individuals vary and depends on filing status:

- Married taxpayers, filing jointly \$250,000
- Married taxpayers, filing separately \$125,000
- Other individual taxpayers \$200,000

Medicare surtax and trusts and estates

The annual surtax payable by a trust or estate is 3.8% of the lesser of either (1) the undistributed NII or (2) the excess of AGI over the top income tax bracket amount for trusts and estates, which is \$15,650 in 2025. The surtax should not apply to grantor trusts or to simple trusts. The grantor is taxed with all income earned in a grantor trust, and simple trusts (such as marital deduction trusts) require all income to be distributed, so undistributed NII would ordinarily be zero.

*Net Investment Income Tax, 26 US Code Sec. 1411, 2013.

Planning to reduce the impact of the surtax

Although at CIBC Private Wealth we do not recommend that investment planning be driven solely by tax considerations, there are some steps that may be appropriate to consider in your overall asset allocation and wealth planning.

- **Tax-exempt bonds.** While interest on corporate bonds is NII, interest on tax-exempt bonds is not. The surtax may be reduced by switching from corporate bonds to tax-exempt bonds, taking into consideration total after-tax return.
- **Investment losses.** Since NII includes only net investment income, investment losses can reduce investment income from an activity and may create a net loss that can be used to offset investment income from other activities.
- **S-corporations.** S-corporations (S-corps) provide for a single level of taxation similar to partnerships; however, unlike a partnership or limited liability corporation, the earnings of an active business conducted as an S-corp are not subject to self-employment taxes. Therefore, income from an active trade or business conducted in an S-corp should not be subject to either self-employment tax or the surtax. Note that there are tax provisions that require payroll taxes to be paid on a reasonable salary.
- **Roth IRA conversions.** The MAGI rules for IRAs are as follows:
 - Distributions from traditional IRAs are included in MAGI.
 - Roth IRA conversions are included in MAGI.
 - Distributions from Roth IRAs are not included in MAGI.
- **Charitable remainder trusts.** The surtax does not apply to CRTs (CRATs or CRUTs) because they are exempt from tax under IRC section 664(c). Income from these trusts will be included in MAGI only to the extent of annual distributions to the individual beneficiary, enabling the taxpayer to spread out MAGI and avoid having it exceed the threshold amount in any given year.
- **Installment sales.** Installment sales can also be used to spread out NII. They may enable a taxpayer to avoid surtax exposure in the year of sale and thereafter.
- **Oil and gas investments.** If a taxpayer has particularly high income (and surtax) in a given year, the intangible drilling costs (IDCs) associated with oil and gas investments may produce a large current deduction. This deduction may be as much as 80% of the amount invested in a well.
- **Life insurance.** Withdrawals up to basis and loans against the cash value of a permanent life insurance policy are generally not subject to this surtax. Death benefit is also generally not considered NII.
- **Above-the-line deductions.** Deductions that can be claimed on page one of Form 1040 reduce MAGI. Two of the most important are contributions to qualified plans and traditional IRAs, as well as charitable contributions.

Understanding the types of income that are subject to the Medicare surtax can help taxpayers plan to reduce its impact. Your CIBC Private Wealth relationship manager can help you work with your tax advisors to create the right strategy for you.