How the New Wealth Taxes Will Hit You

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The health-care bill that Congress passed in March contained two surprising new taxes to help pay for the changes: an extra 0.9% levy on wages for couples earning more than $250,000 ($200,000 for singles) and a new 3.8% tax on investment income on those same people (technically, people with "adjusted gross incomes" above those amounts).

Each tax signals a radical change in policy. For workers, the extra 0.9% levy puts a progressive element in what used to be a totally flat tax. The 3.8% tax on investment income also knocks down a longstanding wall by applying a "payroll" tax to unearned income. Until now, FICA taxes for Social Security and Medicare have applied only to wages, not investment income.

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While many details remain unclear and the Internal Revenue Service hasn't issued any guidance, here are preliminary answers to the most important questions taxpayers are asking.

These taxes take effect in 2013, two elections away. Might they be repealed first?

Not likely. "Congress would have to undo the health reform, and budget constraints would still be there," says Clint Stretch of Deloitte Tax. "Even if Republicans take control of Congress, President Obama holds the veto pen until Jan. 20, 2013."

President Obama's health-care overhaul imposes new taxes on earnings. (Getty Images)

How does the 0.9% tax work?

If Joe and Mary each earn $175,000, their total employment income is $350,000. Currently they owe 1.45% -- $5,075 -- of regular Medicare tax, and their employers owe a matching amount. In 2013, the couple will owe an extra 0.9% -- $900 -- on their wages above $250,000, which is $100,000. Their employers pay nothing extra.

What about the 3.8% tax on net investment income?

This levy is keyed to "modified adjusted gross income," with a threshold of $250,000 for couples and $200,000 for singles. (This is simply adjusted gross income for nearly everybody except expatriates, who must add back certain exclusions.) The tax is a flat 3.8% on investment income above the threshold.

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How would this work?

Example 1: John and Jane, a married couple, have $400,000 of AGI -- $200,000 of wages plus $200,000 of investment income. Because they have $150,000 of investment income above the $250,000 threshold, they would owe an extra $5,700.

Example 2: Anne, a single filer, earns $40,000 but has an investment windfall of $190,000, for total income of $230,000. Because she has investment income of $30,000 above her $200,000 threshold, she would owe $1,140 of additional tax.

Example 3: Retirees Mary and Bill have no wages but they do have a taxable IRA payout of $90,000, plus investment income of $150,000, for a total of $240,000. They don't owe the new tax, because they have no investment income above the $250,000 threshold.

What is investment income?

Interest, except municipal-bond interest; dividends; rents; royalties; and capital gains on the sales of financial instruments like stocks and bonds. The taxable portion of insurance annuity payouts also counts, unless it is from a company pension. So do gains from financial trading, as well as passive income from rents and businesses you don't participate in. All are subject to the 3.8% tax on amounts above the $250,000 or $200,000 threshold, as described above.

Not taxed: Distributions from regular and Roth IRAs and other retirement accounts, including pensions and Social Security, and annuities that are part of a retirement plan. Life-insurance proceeds, muni-bond interest and veterans' benefits don't count, nor does income from a business you participate in, such as a Subchapter S or partnership.

Could the 3.8% tax apply to gains on the sale of a home?

Yes, if there is a taxable gain above the $500,000 ($250,000, single) exclusion for gains on the sale of your residence.

Example: Fred and Fran, who bought their home in a New York suburb for $50,000 in 1972, sell it in 2013 for $1 million. After subtracting the $50,000 cost and $500,000 exclusion, they have investment income of $450,000. If they also have a taxable IRA payout of $70,000 and a pension of $30,000, they would owe the tax of $11,400 on $300,000.

What happens if a taxpayer who owes the new tax on investments also has a large itemized deduction -- say, medical expenses or a theft loss?

Even if taxable income is zero because of deductions, he or she could still owe the 3.8% tax. Example: Myra is a single filer with investment income of $100,000 and wages of $200,000. But during the same year she loses $300,000 in a Ponzi scheme. She pays no income tax, but she still owes the new Medicare tax of $3,800 on her net investment income, says Sharon Kreider, a tax expert in Sunnyvale, Calif.

Does the 3.8% tax affect trusts and estates?

Yes, and it can hit them hard. The tax is levied on investment income as low as $12,000 that isn't paid out to beneficiaries. Some believe the tax may also hit children's unearned income subject to the "kiddie tax" if the parents owe it themselves.

What professions are able to avoid this tax?

Ms. Kreider and others see a sweet spot for real-estate professionals. The law deems their rents to be "active" income, so they wouldn't be subject to the investment tax. Often they don't owe self-employment taxes on that rental income, either.

What steps do experts recommend to minimize these taxes, other than taking capital gains before 2013 or buying municipal bonds?

• Examine both your regular and investment income: the higher your regular AGI, the more likely that your investment income will be subject to the new tax. So while Social Security and pensions don't count as investment income, they raise AGI. This makes Roth IRA conversions even more attractive for many. "Roth withdrawals don't raise AGI and aren't investment income," says Vern Hoven, a tax expert in Gig Harbor, Wash.

• Reconsider a defined-benefit pension if you're eligible -- say, you're in a small business or have consulting income, says Mark Nash of PricewaterhouseCoopers. Pension payouts don't count as investment income, and the older a taxpayer is, the more he can contribute.

• Taxpayers selling assets should consider installment sales, says Ms. Kreider, if spreading out the income would minimize the new tax.

• For some, life insurance may become more attractive. Because life-insurance proceeds at death aren't subject to this tax, a taxpayer could buy a policy, borrow from it and settle up at death, avoiding income tax on investment gains within the policy. But Mr. Nash cautions that the savings must outweigh the fees and other disadvantages such policies may have.

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