

Affordable Care Act Taxes

Strategies for Higher Income Earners

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The Affordable Care Act (ACA), commonly referred to as “Obamacare,” added a number of provisions to the internal revenue code, beginning in tax year 2013. Among them are two provisions that continue to affect taxpayers with higher earned income. This article outlines general tax-planning considerations that may be relevant to certain taxpayers.

The following taxes associated with the ACA impact many higher income earners, as well as certain estates and trusts.

- **Additional Medicare Tax:**¹ This 0.9% payroll surtax applies to wages, railroad retirement (RRTA) compensation, and self-employment income above \$200,000 for individuals, and \$250,000 for married couples filing jointly.
- **Net Investment Income Tax (NIIT):**² The law adds a 3.8% tax on certain types of unearned income, including interest, dividends, capital gains, and other investment income.

Understanding the Additional Medicare Tax

Earned income is subject to the Medicare payroll tax of 2.9%, with workers and employers each paying 1.45% and self-employed individuals paying both the employee and employer portions. All earned wages, compensation, and self-employment income are subject to the Medicare tax, with no upper limit. This differs from the Social Security payroll tax, which is only applied to earnings up to an annual maximum, or wage base limit.

Under the ACA tax provision, higher income earners are subject to an additional 0.9% on wages, compensation and self-employment income that exceeds the applicable thresholds based on their tax filing status. The threshold is \$250,000 for married couples filing jointly, \$125,000 for married couples filing separately, and \$200,000 for individual taxpayers and all others. Since these thresholds are not indexed for inflation, more taxpayers are subject to these taxes as incomes increase over time.

How the Additional Medicare Tax Works

The example below assumes that a married couple filing jointly has a modified adjusted gross income (MAGI) of \$300,000 and combined wage income of \$280,000.

The amount of wage income above \$250,000 is subject to the 0.9% surtax, so the couple pays \$270 (\$30,000 x 0.9%) in taxes, in addition to the standard 1.45% Medicare payroll tax.

For the \$30,000 subject to the surtax, the effective employee portion of the Medicare payroll tax is 2.35%.

Keep in mind that employers are required to withhold the Additional Medicare Tax on wages paid to employees that exceed \$200,000, regardless of an employee's filing status. For married taxpayers, or employees with multiple jobs, this could result in either over withholding or under withholding, which gets addressed when filing their federal tax return.

How NIIT is Taxed

A 3.8% tax on net investment income could apply if your MAGI exceeds the applicable threshold. For individuals, the tax applies as outlined in Exhibit 1¹.

Exhibit 1: For individuals, the 3.8% tax applies to the lesser of:

Modified adjusted gross income that exceeds

- \$200,000 for single filers;
- \$250,000 for married taxpayers filing jointly;
- \$125,000 for married taxpayers filing separately

Net investment income

- Which is investment income (as defined in Exhibit 2) reduced by those deductions properly allocable to the investment income

MAGI that exceeds the threshold triggers a two-part calculation which looks at the amount of income above the threshold and total net investment income. The surtax applies to the lesser of the two.

For example, a single taxpayer with \$250,000 in MAGI for the 2025 tax year would be \$50,000 over the threshold. Assuming their net investment income is \$10,000, which is lower than \$50,000, they would be subject to a surtax of \$380 (\$10,000 x 3.8%). (This example is for illustrative purposes only and does not represent actual or personalized tax outcomes.)

Keep in mind that this surtax is a separate tax that can apply in addition to ordinary income tax or the Alternative Minimum Tax (AMT).



Exhibit 2: Net Investment Income³

Net Investment Income includes income from:

- Interest
- Dividends
- Non-qualified annuities
- Royalties
- Rents
- Gain from the sale/disposition of certain property (capital gains)
- Substitute dividend/interest payments (e.g. payments in lieu of dividends)
- A trade or business that is considered a passive activity (under the passive loss rules) or is in the business of trading in financial instruments or commodities/related derivatives.

But does not include:

- Wages, Social Security benefits, unemployment compensation
- Self-employment income that is taken into account for Self-Employment Contributions Act (SECA) tax purposes
- Qualified retirement plan distributions
 - IRAs, 401(k)s, pensions, etc.
- Non-qualified deferred compensation (NQDC) distributions
- Tax-exempt income
 - Municipal bond interest
 - Excluded gain on sale of a principal residence
 - Life insurance death benefits, etc.
- Trade or business income other than income from a trade or business described in the final bullet on the left. However, income from the investment of working capital does not fall within this exception.

Managing the impact of taxes on earned income

There are steps taxpayers can take to reduce the likelihood of crossing the applicable MAGI threshold levels, limit the amount by which thresholds are exceeded, and/or lower net investment income for certain years.

Individuals should consult their tax professional before implementing any strategy.

Certain taxpayers may consider the following to potentially reduce MAGI, depending on their individual circumstances. Keep in mind, eligibility varies and these options are not always appropriate or available to all taxpayers.

1. Enrolling in a non-qualified deferred compensation plan (NQDC), if eligible. These steps may reduce taxable wage income for eligible contributors; however, individual outcomes will vary.
2. Contributing up to the maximum pre-tax amount to a workplace retirement plan, such as a 401(k) or 403(b) defined contribution plan (including catch-up contributions for those age 50 and older).
3. Contributing all or a portion of your self-employment or contractor income (Form 1099 income), if applicable, to a Simplified Employee Pension IRA or an Individual 401(k) plan that you can set up on your behalf.

These steps may reduce taxable wage income for eligible contributors, as well as permit tax-deferred growth. However, individual outcomes will vary. When distributed in the future, the taxable amounts will contribute to MAGI in the year of distribution but will not be included as net investment income under the 3.8% tax.

Taxes are only one aspect of a thoughtful financial plan. We believe financial and investment decisions should be made in consultation with your advisor and should consider your specific goals, time horizon, and risk tolerance.

To place even more dollars in a tax-deferred account, consider the two steps outlined below. While both require making after-tax contributions that will not reduce your current MAGI, they do enable you to potentially accumulate more assets in tax-deferred vehicles. This means any earnings growth realized within the account will not affect capitalized MAGI, and any future distributions will not be included as net investment income. For example:

- 1. After-tax 401(k) contributions:** If your plan allows, you may be able to make a third type of contribution to your workplace savings plan, in addition to pre-tax and Roth salary deferrals. Even if you have maximized your salary deferral amount in your pre-tax and/or designated Roth account in your 401(k) plan, and your catch-up contributions if you're age 50 or over, you may be able to contribute more of your wages to help you get closer to the 401(k) plan Section 415(c) limit of \$72,000 for the 2026 tax year. Consult with a tax professional to determine suitability.
- 2. Non-deductible IRA contributions:** You and your spouse can contribute to a traditional IRA even if you are not eligible to make deductible contributions and even if your spouse does not have earned income.

Tax efficient ways to acquire Roth assets

Many higher income earners may not be eligible to contribute to a Roth IRA. However, there are two potential strategies for acquiring Roth assets even if this is the case.

- 1. Roth conversion:** Income limits do not apply to Roth conversions. For accounts that could have a high percentage of after-tax vs. pre-tax dollars (such as an after-tax account in your workplace plan), a Roth conversion may make sense. Any converted pre-tax dollars are included as ordinary income in the year of conversion, increasing MAGI for that year, but will not count as investment income under the 3.8% tax. The converted after-tax dollars are not subject to taxation.
- 2. Roth contributions to an employer plan:** Designated Roth accounts in a workplace retirement plan are another consideration since there are no income limits on Roth contributions in a defined contribution

plan, such as a 401(k) or 403(b). However, these contributions will not lower your MAGI. An important benefit of acquiring Roth assets is that qualified distributions are tax free and therefore do not count under either MAGI or net investment income.

Asset allocation and asset location

Managing after-tax returns and reducing tax drag on an investment portfolio is a critical objective for most investors. That's why a strategy that considers both asset allocation and asset location is critical for pursuing these objectives. After all, it's what you keep that counts.

- **Asset allocation:** Investors with fixed income investments and taxable accounts who are concerned about improving after-tax returns may wish to review their allocation to tax-exempt securities. Municipal interest and municipal bond fund dividends are neither included under MAGI nor under net investment income (Note that capital gains from the sale of municipal securities are subject to both).
- **Asset location:** Asset location is another important consideration for investors whose holdings include taxable fixed income investments. Through consolidation of retirement plans, investors may be able to locate the most highly taxed fixed-income investments – those subject to both ordinary income tax rates and potentially to the NIIT – into tax-deferred vehicles.

Investors who are still working and are not looking for current income may want to consider shifting certain income-producing assets from taxable to tax-deferred accounts. Then, when the income is distributed in the future, the taxable portion will be included as ordinary income (perhaps in a lower tax bracket) and will not count as net investment income, unless held in a non-qualified annuity. Consult with a tax professional to determine suitability.

Keep in mind that tax legislation is uncertain and subject to change without notice. It's also important to remember that tax considerations are only one aspect of a comprehensive financial strategy. Financial and investment decisions should always be made based on your individual goals, time horizon, risk tolerance, and personal definition of a life well lived.

^{1, 2, 3}IRS.gov, <https://www.irs.gov/individuals/net-investment-income-tax>

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