
IRS issues final regulations on Additional Medicare Tax for high wage earners

December 31 last chance to implement new withholding procedures

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In brief

The Internal Revenue Service (IRS) recently issued final regulations providing guidance to employers and individuals regarding the implementation of the additional Medicare tax (Additional Medicare Tax). The final regulations come nearly one year after the IRS issued proposed regulations and aim to clarify the 0.9% Additional Medicare Tax now imposed on higher income individuals. The final regulations largely mirror the proposed guidance as the IRS received few substantive comments in response to the proposed regulations. The rules provide specific guidance with respect to the employer's withholding and reporting obligations as well as the process for making adjustments and claiming refunds.

In detail

What is the Additional Medicare Tax?

Effective January 1, 2013, individuals must pay an additional 0.9% Medicare tax on income earned above certain thresholds. This tax applies to both wage income and self-employment income. Specifically, the employee portion of the Medicare tax was increased from 1.45% to 2.35% on wages received in a calendar year in excess of \$200,000 (\$250,000 for married couples filing jointly; \$125,000 for married filing separately). The Additional Medicare Tax differs

from the regular Medicare tax in that there is no employer match; thus, the employer's Medicare tax rate on wages continues to be 1.45%.

Employer's withholding obligation

Employers are required to withhold the additional 0.9% Medicare tax in the pay period in which the employee's wages exceed \$200,000, regardless of the employee's filing status or other income. Thus, an employer is obligated to withhold regardless of whether the employee is ultimately liable for the tax. For example, if an employee's filing status is

'married filing joint' and he or she earns \$225,000 of wages but his or her spouse does not earn any wages in the calendar year, the Additional Medicare Tax imposed on the \$25,000 (\$225,000 - \$200,000) of excess wages will be credited against the total tax liability shown on the employee's personal income tax return (Form 1040) since the total wages earned did not exceed the threshold amount of \$250,000.

Alternatively, an employee may not earn over \$200,000, but be subject to the additional 0.9% Medicare tax (eg, a married person filing a separate return is

subject to the tax on earnings over \$125,000). Or an individual's wages may not exceed \$200,000, but when combined with a spouse's wages, total wages exceed the \$250,000 threshold. In such a case, the employee is responsible for calculating and paying the Additional Medicare Tax. Although an employee cannot request additional withholding specifically for the Additional Medicare Tax, he or she can either make quarterly estimated tax payments or submit a new Form W-4, *Employee's Withholding Allowance Certificate*, requesting additional income tax withholding. The additional income tax withholding will be applied against all taxes shown on the employee's personal income tax return.

If an employer fails to withhold the correct amount of Additional Medicare Tax, it will be liable for the tax unless it can demonstrate that the employee paid the tax. This rule is analogous to the federal income tax withholding provisions, which require the employer to provide documentary evidence that the individual filed a personal tax return and paid the applicable taxes due. This remedy, however, does not provide relief from potential penalties that may apply for failure to withhold and remit the correct amount of employment taxes.

Employer and employee reporting obligations

Employers are required to report the Additional Medicare Tax on Form 941, *Employer's Quarterly Tax Return*. The IRS issued a revised form at the beginning of 2013 that includes a special line item for the withholding liability associated with the Additional Medicare Tax. The existing line

related to regular Medicare wages and tax remains unchanged. With respect to Form W-2, any Additional Medicare Tax withholding should be combined with the regular Medicare taxes in Box 6.

Individuals will report Additional Medicare Tax on Form 8959, *Additional Medicare Tax*, and attach it to their income tax returns. The IRS recently issued draft instructions for the Form 8959 to help taxpayers determine how much they owe and how much of the tax was withheld by their employers.

Employment tax adjustments and claims for refund

The final regulations also provide rules for when and how employers may make interest-free adjustments to correct overpayments or underpayments of Additional Medicare Tax and how employers and employees may claim refunds for overpayments of the tax. These procedures are analogous to the existing rules that apply to federal income tax withholding because like federal income tax withholding, the Additional Medicare Tax does not include an employer portion and the ultimate liability is reconciled on the individual's income tax return.

As a result, if an employer fails to withhold the correct amount of Additional Medicare tax, it can generally make an interest-free adjustment only if it discovers the error in the same year in which the wages are paid. The IRS noted that allowing employers additional time beyond the end of the calendar year would create complexity and confusion for individuals filing

individual income tax returns and, thus, would adversely affect tax administration. Accordingly, the final regulations do not include special procedures for correcting the Additional Medicare Tax, but instead, mirror the existing procedures for correcting federal income tax withholding errors.

In addition, the final regulations provide a process for employers and individuals to claim a refund of overpaid Additional Medicare Tax. If the employer overpays but does not deduct or withhold the overpaid amount from the employee's compensation, then the employer may claim a refund of the overpaid amount on Form 941-X. In contrast, an individual may claim a refund on his or her Form 1040 to the extent the employee did not receive repayment or reimbursement from the employer.

The takeaway

While the final regulations were recently released, the rules went into effect on January 1, 2013. If employers failed to implement these new procedures, they have a short period of time (until December 31, 2013) to correct any underpayments associated with the Additional Medicare Tax.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact one of the individuals listed below or a member of your local Tax Controversy and Regulatory Services practice:

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