

**PHILADELPHIA BAR ASSOCIATION
PROBATE SECTION TAX COMMITTEE**

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**SECTION 1411 – “MEDICARE”
TAX ON NET INVESTMENT INCOME**

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Section 1411 – “Medicare” Tax on Net Investment Income

I. OVERVIEW

A. Enacted by The Health Care and Education Reconciliation Act of 2010, creating Section 1411 of the Internal Revenue Code,

B. Effective January 1, 2013, high-income taxpayers (including trusts and estates) will be subject to a new 3.8% Medicare tax on net investment income.

C. Uncertain whether the net investment income tax is required to fund Medicare or is part of general tax revenues. It is certain that the .9% tax on “excess” compensation will be used to fund Medicare.

II. NET INVESTMENT INCOME TAX - INDIVIDUALS

A. This net investment income tax applies to those taxpayers whose “modified adjusted gross income” exceeds the \$200,000 threshold for single status filers and \$250,000 threshold for married filing jointly.

- Does not apply to nonresident aliens.

B. Thresholds are not indexed for inflation.

C. 3.8% tax applies to the **lower** of (1) a taxpayer’s net investment income or (2) the amount that the taxpayer’s modified adjusted gross income exceeds the applicable threshold.

D. **Modified Adjusted Gross Income** means AGI without the effect of Section 911 (exclusion of income and deductions for U.S. citizens living abroad).

III. NET INVESTMENT INCOME TAX - TRUSTS & ESTATES

A. The new net investment income tax also applies to estates and trusts, except for the following:

- Trusts subject to section 1411 – generally applies to all subchapter J trusts, unless specifically excepted. Excepted trusts include:
 - tax-exempt trusts (including charitable remainder trusts)
 - business trusts
 - foreign trusts (although the proposed regulations reserved rules for foreign trusts with U.S. beneficiaries)
 - grantor trusts
- Estates subject to section 1411 – all estates except:
 - bankruptcy estates treated as an individual
 - foreign estates (although the proposed regulations have a reserved provision for certain foreign estates with U.S. beneficiaries)

B. The 3.8% tax applies to the **lower** of (1) the “**undistributed**” **net investment income** for the taxable year or (2) the excess of the estate or trust’s adjusted gross income for the taxable year over the dollar amount at which the highest tax bracket begins for estates and trusts (i.e., **\$11,950** for 2013).

C. NOTE – The additional 5% tax (in the form of a 20% rate) applies to long-term capital gains and qualified dividends for trusts and estates in the highest bracket. The tax applies to the excess over **\$11,950**.

IV. NET INVESTMENT INCOME TAX - DEFINITIONS

A. “Net investment income” includes interest, dividends, annuities, royalties, rents, **passive activity income** and net gains from the disposition of property other than property held in an active trade or business (to the extent that it is recognized in taxable income). Capital losses are not deductible against the other investment income.

- Specifically includes “trade or business of trading in financial instruments or commodities.” In other words, hedge fund income. That is not always treated as “passive income” under Section 469.
- Capital loss carryovers from earlier years can be used to offset net capital gains in a current year.

B. Investment income does **not** include income from an active trade or

business, distributions from qualified pension plans, nonqualified deferred compensation or municipal bond interest. However, some of this income is included in AGI, so may indirectly trigger the tax.

C. **Disposition of Interests in Partnerships and S Corporations**

- The gain or loss from the disposition of a partnership interest or S corporation stock can be adjusted if the entity held property as part of a trade or business – i.e., only the net gain or loss from the sale of nonbusiness assets should be included in “net investment income”.
- However, the above rule applies **only if the business is not passive as to the transferor of the interest, so (as discussed below) it will likely not be applicable to most trusts.**

D. Calculation of net investment income allows deductions that are “properly allocable” to such investment income.

E. **Undistributed Net Investment Income**

- As determined under Prop. Regs. §1.1411-3(e), “undistributed net investment income” of an estate or trust is its “net investment income” reduced by distributions of net investment income to beneficiaries and amounts paid or permanently set aside for a charitable purpose.

V. **NET INVESTMENT TAX - PASSIVE ACTIVITIES**

A. Passive activity rules of Section 469 are key.

B. Passive Activity is defined as one which a taxpayer does not materially participate.

- Rental activities are per se passive activities unless the taxpayer is a real estate professional.
- Working interests in oil and gas properties are per se nonpassive activities unless the taxpayer’s form of ownership limits liability.

C. Material participation means involvement in an activity on a regular, continuous and substantial basis.

D. Temporary Treasury Regulations have a variety of tests to determine whether an individual is materially participating. Some of the key tests include:

- Individual's participation >500 hours per year or constitutes substantially all of the participation in such activity;
- Individual's participation >100 hours with no individual participating more;
- Activity is a personal service activity and the individual materially participated for any three taxable years preceding the taxable year;
- Facts and circumstances.

E. Application to Trusts and Estates:

- The issue with trusts and estates is when (maybe whether) a trust or estate can ever avoid the passive income rules;
- The IRS' position is that the material participation rules are applied at the trust level – i.e., it is the Trustee's activities in its fiduciary role that determine it. (TAM 201317010 and PLR 201029014) Under the IRS' rules, it is going to be next to impossible to avoid the passive rules.
- However, there is a District Court case, **Mattie K. Carter Trust v. U.S. F. Supp. 2d 536 (N.D. Tex. 2003)** that allows the material participation rules to be applied by addressing the activities of the trust through its **fiduciaries, employees and agents – not just the Trustees.**
- There are different rules for Electing Small Business Trusts ("ESBT"s) and Qualified S Trusts ("QSST"s). In a QSST, the beneficiary is deemed to be the owner, so the beneficiary's activities can be used for qualifying the interest as active.

VI. Example

In 2013, a complex Trust has dividend income of **\$15,000**, interest income of **\$10,000**, capital gain of **\$5,000** and **\$60,000** of taxable income relating to a distribution from an IRA. The Trust has no expenses. Trust distributes **\$10,000** of its current year fiduciary accounting income to A, a beneficiary of Trust. For trust accounting purposes, **\$25,000** of the distribution from the individual retirement account is attributable to income. The Trust allocates

the remaining **\$35,000** of taxable income from the IRA and the **\$5,000** of capital gain to principal and are not part of DNI for 2013.

The Trust's DNI is **\$50,000** (**\$15,000** in dividends plus **\$10,000** in interest plus **\$25,000** of taxable income from the IRA), from which the **\$10,000** distribution to A is paid. Trust's deduction under Section 661 is **\$10,000**. Under Treas. Reg. § 1.662(b)-1, the deduction reduces each class of income comprising DNI (20% of each class). Accordingly, the distribution to the income beneficiary A is comprised of dividend income of **\$3,000**, interest income of **\$2,000** and ordinary income attributable to the individual retirement account of **\$5,000**. Since the **\$5,000** of capital gain allocated to principal for trust accounting purposes did not enter into DNI, no portion of that amount is included in the **\$10,000** distribution, nor does it qualify for the deduction under Section 661.

The Trust's NII is **\$30,000** (**\$15,000** in dividends plus **\$10,000** in interest plus **\$5,000** in capital gain). Trust's **\$60,000** of taxable income attributable to the IRA is excluded income per Prop. Reg. § 1.1411-3(e)(5) since it is not included in NII per Prop. Reg. § 1.1411-8. The Trust's undistributed NII is **\$25,000**, i.e., the Trust's net investment income (**\$30,000**) less the amount of dividend income (**\$3,000**) and interest income (**\$2,000**) distributed to A. The **\$25,000** of undistributed NII net investment income is comprised of the capital gain allocated to principal (**\$5,000**), the remaining undistributed dividend income (**\$12,000**) and the remaining undistributed interest income (**\$8,000**).

The amount of income subject to the 3.8% tax is **\$25,000 - 11,950 = \$13,050**. The tax is **\$496**. The capital gain would also be subject to a 20% capital gain rate. If the dividends were "qualified", some of them may be subject to the 20% rate as well.

VII. NET INVESTMENT INCOME TAX - PLANNING

- A. Spread income over time or into later years
 - Tax-deferred investments (annuities)
 - Life insurance
 - Installment sales
- B. Tax-exempt bonds (as opposed to corporate bonds)
- C. Oil and gas investments in a non-passive entity form
- D. Trusts can distribute income to the beneficiary
 - However, that income will then need to be included in the

individual beneficiary's income when calculating the applicable individual threshold.

VIII. EFFECTIVE DATE

A. The effective date of the tax rate increases is for tax years which begin after December 31, 2012.

B. For pass-through entities that have a difference tax year, which "tax year" is key.

- Shareholder's tax year?
- Entity's tax year?
- Tax year in which the entity received the amount it is distributing?