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New 3.8% Medicare Tax on Investment and Unearned Income Beginning in 2013

Starting January 1, 2013, a new 3.8% Medicare[1] tax will apply to the investment and "unearned income" of individuals, trusts and estates. The tax is intended to apply to income exempt from the regular FICA or self-employment taxes. Avoiding or reducing the impact of this new 3.8% tax will require sophisticated tax planning both pre- and post-January 1, 2013. However, it may be difficult to reduce the impact of this new tax, especially for taxpayers with significant amounts of investment and unearned income. The last part of this memorandum describes certain tax planning ideas that may be suitable for taxpayers depending on their particular tax and economic status.

Specifically, beginning January 1, 2013, a new 3.8% Medicare tax will apply to the *lesser* of a taxpayer's (i) net investment income or (ii) the excess of the taxpayer's modified adjusted gross income (MAGI) over a threshold amount. MAGI in the case of an individual generally equals an individual's adjusted gross income with certain technical adjustments. For married individuals filing joint returns, the threshold amount is $250,000 and for single individuals the threshold amount is $200,000. In the case of a trust or an estate, the tax is imposed on the lesser of (i) "undistributed" net investment income or (ii) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to a trust or estate begins (currently $11,650). Therefore, the low limits at which the tax can apply will force trusts and estates to pay particular attention to the tax. However, simple trusts that provide only for distributions of current income, and whose terms require all current income to be distributed, will avoid the new tax (although the trust beneficiaries may not). Also, the new tax does not apply to trusts where all unexpired interests are devoted to charitable purposes. For all taxpayers, the most important part of the new tax is the definition of "net investment income." Net investment income is generally defined as investment income reduced by properly allocable deductions. Investment income generally will include all of the following:

- Interest, dividends, annuities, royalties and rents (with certain exceptions).
- Capital gain from the sale of stocks, bonds and other securities.
- Income from a trade or business that is a "passive activity" with respect to the taxpayer and conducted by an entity taxed as a partnership, limited liability company or S corporation.

- Net gain from the sale of an interest in a partnership, LLC or S corporation to the extent attributable to a trade or business which is a "passive activity" with respect to the taxpayer.
- Income from the trade or business of trading in financial investments or commodities.

In general, an activity is passive with respect to a taxpayer if the taxpayer does not "materially participate" in the trade or business. Material participation is determined under the passive loss rules and can involve a highly complex analysis. In general, working in the business more than 500 hours a year will avoid passive treatment, but other more liberal tests may also be satisfied, some of which depend on the ownership structure and others that require as few as 100 hours of annual participation.

Some additional examples of income subject to the new tax include taxable distributions from mutual funds and the taxable portion of gain recognized upon the sale of a primary residence. Equally important are the categories of income generally exempt from the new tax:

- Income or gain from a trade or business conducted by a partnership, LLC or S corporation to the extent the trade or business is not a passive activity (except to the extent the trade or business earns investment income, e.g., on working capital).
- Distributions from tax-qualified pension and profit sharing plans and IRAs, although they may increase MAGI.
- Tax-exempt interest.
- The portion of the gain from the sale of a primary residence that is excluded from income.
- Income and gain already subject to the tax on self-employment income. Thus, income and gain from a business which is not a passive activity to the taxpayer will not be subject to the new tax. However, except in the case of an S corporation, earned income from a pass-through entity that is not a passive activity will be subject to an increase in the existing Medicare surcharge (the tax on self-employment income) from 2.9% to 3.8%. In general this tax increase will affect taxable income exceeding $250,000 for married taxpayers and starts in 2013.

The amount of the new tax will have to be taken into account in figuring a taxpayer's quarterly estimated tax payments and the tax is non-deductible.

Income Tax Planning Ideas

While not intended as a complete list, the following are some planning ideas to consider to reduce the impact of the new tax:

- Invest in tax-exempt bonds.
- Accelerate into 2012 any investment income that would otherwise be subject to the new tax in 2013, e.g. accelerate the sale of stocks and bonds.
- Defer unrealized capital losses to 2013 to offset capital gains subject to the new tax.
- Increase contributions to tax-qualified plans rather than investing outside such plans (although distributions from such plans may increase MAGI). Also, note that this technique may be less attractive if the current lower rates on dividends and capital gains on assets held outside such plans are extended by legislation.

- Harvest passive losses in future years to offset passive income and gains (although the ability to do so will depend on IRS interpretations).
- Revisit ownership structures that affect the treatment of an activity as passive.
- To the extent an entity provides for tax distributions to its members, partners or shareholders, consider adding the new tax as an additional distribution, if appropriate.

Of course, any tax planning should also make sense from an investment and economic perspective. For example, trade-offs may exist: classifying a taxpayer's trade or business activity as active rather than passive will avoid the new tax from being imposed on the taxpayer's income and gain from the business. But the switch from active to passive activity will also prevent a taxpayer's reclassified passive losses from offsetting income and gain from the trade or business.

Please note that the IRS has not yet issued any guidance on a variety of interpretive questions and that all of the above is subject to modification depending on such guidance. Some of the issues that should be addressed in the guidance include the following:

- How to allocate expenses in figuring net investment income.
- Can pre-2013 passive losses be used to offset post-2012 passive income otherwise subject to the new tax?
- In the case of real estate professionals whose rental income is generally treated as not passive, how will rental income be treated as derived in the "ordinary course of a trade or business" (which would exempt rent from the new tax)?
- In the case of trusts, how will the trust determine whether it is "participating" sufficiently in an activity so as to avoid causing the activity to be passive (which would exempt the trust from the new tax? Will the services of employees and agents be attributed to the trustee?
- In the case of a trust that receives multiple classes of income, how will the trust determine which type of income is "undistributed" net investment income subject to the new tax?

In the meantime, taxpayers potentially affected by this new tax should consult their tax advisers.

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[1] Although the legislation appears in the provisions of the Internal Revenue Code dealing with Medicare taxes, the receipts from the new tax will not be used to fund Medicare but will be added to the general tax revenues of the government. The tax was enacted as part of the Obama healthcare legislation.

If you have questions on this or any tax issue, you may contact your Thompson Coburn attorney or one of the attorneys listed below:

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