

Health Care Legislation Tax Increases Effective in 2013

The Additional Medicare Tax
The Tax on Investment Income

Overview

The Affordable Care Act added two broad-based additional taxes, an increase in the Medicare tax, and an excise tax on investment income.

Both are effective for years beginning after 2012 with threshold amounts of:

- \$200,000 for single taxpayers and heads of households,
- \$250,000 on joint returns and
- \$125,000 on the returns of married taxpayers filing separately.

The threshold amounts are not adjusted for inflation.

The taxes will be computed on Forms 8959 and 8960, respectively, and reported on page 2 of Form 1040. The IRS released draft forms in August.

Additional Medicare Tax

The Medicare tax is increased by .9%, from 1.45% to 2.35%, on wages and income from self-employment above \$200,000, \$250,000 on a joint return and \$125,000 on the return of a married taxpayer filing separately.

Proposed Regulations

On December 5, 2012, the IRS issued proposed amendments to regs. at 1.1401-1, 31.6205-1, 31.6402(a)-2, 31.6413(a)-1 and 31.6413(a)-2. They provide guidance as to computations, withholding thresholds and reporting requirements.

- Taxpayers with wages and/or SE income above the threshold amounts are liable for the additional tax; however, the threshold amount for SE purposes is reduced (not below zero) by the taxpayer's FICA (but not Railroad Retirement Tax Act) wages.

Withholding Requirements

Employers are required to begin withholding the additional tax in the pay period during which they pay wages in excess of \$200,000 to an employee.

- Employers are not required to notify employees that they have begun withholding the additional tax.
- Employees may not request withholding of the additional tax on wages that do not exceed \$200,000, but can request additional income tax withholding on Form W-4.

Employees are liable for any additional tax not withheld.

- The IRS will not collect the additional tax that an employer failed to withhold if the employee subsequently pays it.
 - However, the employer could be liable for penalties (including the penalties for failure to collect and pay at sections 6672 and 7202).
- Employees will claim credit for over-withheld additional tax or pay any additional tax due (e.g., in cases involving multiple employers and/or combinations of wages and SE income), on Form 1040.

Examples

Verbatim from reg. 1.1401-1(d)(2)

Wages and SE Income

Single Taxpayer

Example 3. C, a single filer, has \$145,000 in self-employment income and \$130,000 in wages. C's wages are not in excess of \$200,000 so C's employer did not withhold Additional Medicare Tax. However, the \$130,000 of wages reduces the self-employment income threshold to \$70,000 (\$200,000 threshold minus the \$130,000 of wages). C is liable to pay Additional Medicare Tax on \$75,000 of self-employment income (\$145,000 in self-employment income minus the reduced threshold of \$70,000).

Wages and SE Income Joint Return

Example 4. E, who is married and files a joint return, has \$140,000 in self-employment income. F, E's spouse, has \$130,000 in wages. F's wages are not in excess of \$200,000 so F's employer did not withhold Additional Medicare Tax. However, the \$130,000 of F's wages reduces E's self-employment income threshold to \$120,000 (\$250,000 threshold minus the \$130,000 of wages). E and F are liable to pay Additional Medicare Tax on \$20,000 of E's self-employment income (\$140,000 in self-employment income minus the reduced threshold of \$120,000).

Wages and SE Income

Married Filing Separately

Example 5. D, who is married and files married filing separately, has \$150,000 in self-employment income and \$200,000 in wages. D's wages are not in excess of \$200,000 so D's employer did not withhold Additional Medicare Tax. However, the \$200,000 of wages reduces the self-employment income threshold to \$0 (\$125,000 threshold minus the \$200,000 of wages). D is liable to pay Additional Medicare Tax on \$75,000 of wages (\$200,000 in wages minus the \$125,000 threshold for a married filing separately return) and on \$150,000 of self-employment income (\$150,000 in self-employment income minus the reduced threshold of \$0).

Excise Tax on Net Investment Income

The health care legislation also added a 3.8% excise tax on:

- The lesser of an individual's:
 - Net investment income or:
 - Modified AGI above:
 - \$200,000 for single taxpayers and heads of households,
 - \$250,000 on joint returns and
 - \$125,000 on the returns of married taxpayers filing separately.

And on

- The lesser an estate's or trust's:
 - Undistributed net investment income or
 - AGI above the dollar amount that corresponds to the point at which the highest income tax rate applicable¹⁰ to estates and trusts begins (\$11,950 for 2013).

Proposed Regulations

Proposed regulations at 1.1411-0 through 1.1411-10:

- Identify the individuals, estates and trusts to which the tax applies,
- Define net investment income and
- Set out rules covering:
 - Computations,
 - Application to passive activities and dealers in securities or commodities, and
 - The disposition of interests in passthrough entities.

Individuals, Estates and Trusts

The tax applies to:

- Any individual (including bona fide residents of U.S. territories) except nonresident aliens.
 - A U.S. person married to a nonresident alien is treated as married filing separately, unless the couple has elected to be taxed on their worldwide income on a joint return.
- Any estate or trust subject to part 1 of subchapter J, except grantor and grantor-type trusts, charitable remainder trusts, tax-exempt trusts and foreign trusts.

Electing Small Business Trusts

Electing small business trusts that have assets other than S corporation stock are treated as separate trusts (i.e., the S portion and the non-S portion) for purposes of computing undistributed net investment income, but as a single trust for purposes of determining the amount subject to the excise tax.

- The practical effect of this rule is that losses of the S portion cannot offset income of the non-S portion, or vice versa.

Charitable Remainder Trusts

As noted above, charitable remainder trusts are not subject to the excise tax. However, distributions to beneficiaries (i.e., the annuity or unitrust payments) are deemed to come first from the trust's current and accumulated net investment income.

- As a result, the beneficiary of a charitable remainder trust is required to include the lesser of the amounts distributed or the trust's current and accumulated net investment income in his or her net investment income for the year of the distribution.

Bankruptcy Estates

Bankruptcy estates of individuals are treated as married filing separately for purposes of the excise tax.

Net Investment Income

The regulations generally repeat the broad definition of net investment income at section 1411, which includes net income from:

- Interest,
- Dividends,
- Annuities,
- Rents and royalties not derived in the ordinary course of a trade or business,
- Net gain or loss on the disposition of property not used in a trade or business (including gain or loss on the disposition of rental property) and
- Income from the investment of working capital.

Expenses and Losses

Expenses are allowed against investment income to the extent that they are deductible under general rules, e.g.,:

- Investment interest, limited to investment income,
- Income taxes, allocated between investment income and other income (using any reasonable method) and
- Investment expenses, subject to the 2% floor on miscellaneous itemized deductions and the phase-out of unprotected itemized deductions under section 68.

Losses under section 165 are allowed only to the extent of gains.

- The \$3,000 of excess capital losses allowed against ordinary income under section 1211(b) generally does not reduce net investment income. However, it does reduce section 1245 or 1250 gains included in net investment income, and capital loss carryovers can reduce capital gains included in net investment income.

Verbatim from reg. 1.1411-4(h):

Example 1. Calculation of net gain. (i) In Year 1, A, an unmarried individual, realizes a capital loss of \$40,000 on the sale of P stock and realizes a capital gain of \$10,000 on the sale of Q stock, resulting in a net capital loss of \$30,000. Both P and Q are C corporations. A has no other capital gain or capital loss in Year 1. In addition, A receives wages of \$300,000 and earns \$5,000 of gross income from interest. For income tax purposes, under section 1211(b), A may use \$3,000 of the net capital loss against other income. Under section 1212(b)(1), the remaining \$27,000 is a capital loss carryover. For purposes of determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A's gain of \$10,000 on the sale of the Q stock is reduced by A's loss of \$40,000 on the sale of the P stock. However, because net gain may not be less than zero, A may not reduce net investment income by the \$3,000 of the excess¹⁸ of capital losses over capital gains allowed for income tax purposes under section 1211(b).

Verbatim from reg. 1.1411-4(h)

(ii) In Year 2, A has a capital gain of \$30,000 on the sale of Y stock. Y is a C corporation. A has no other capital gain or capital loss in Year 2. For income tax purposes, A may reduce the \$30,000 gain by the Year 1 section 1212(b) \$27,000 capital loss carryover. For purposes of determining A's Year 2 net gain under paragraph (a)(1)(iii) of this section, A's \$30,000 gain may also be reduced by the \$27,000 capital loss carryover from Year 1. Therefore, in Year 2, A has \$3,000 of net gain for purposes of paragraph (a)(1)(iii) of this section.

Verbatim from reg. 1.1411-4(h)

Example 2. Calculation of net gain. The facts are the same as in *Example 1*, except that in Year 1, A also realizes a gain of \$20,000 on the sale of Rental Property D, all of which is treated as ordinary income under section 1250. For income tax purposes, under section 1211(b), A may use \$3,000 of the net capital loss against other income. Under section 1212(b)(1) the remaining \$27,000 is a capital loss carryover. For purposes of determining A's net gain under paragraph (a)(1)(iii) of this section, A's gain of \$10,000 on the sale of the Q stock is reduced by A's loss of \$40,000 on the sale of the P stock. A's \$20,000 gain on the sale of Rental Property D is reduced to the extent of the \$3,000 loss allowed under section 1211(b). Therefore, A's net gain for Year 1 is \$17,000 (\$20,000 gain treated as ordinary income on the sale of Rental Property D reduced by \$3,000 loss allowed under section 1211.

Passive Activities

Securities / Commodities Traders

NOLs

Net investment income also includes:

- Net income from trades or businesses (but not rents) treated as passive activities under section 469 and
- The net income of traders in securities and/or commodities.

Deductions properly allocated to rents, royalties, passive trade or business income, or income of securities or commodities traders, are allowed to the extent that they are deductible under section 62.

Net investment income cannot be less than zero for any tax year. Consequently, no part of an NOL carryover or carryback is allowed for purposes of computing net investment income.

Verbatim from reg. 1.1411-4(h)

Example 3. Section 172 net operating loss deduction. (i) In Year 1, A, an unmarried individual, has the following items of income and deduction: \$60,000 in wages, \$20,000 in gross income from a trade or business of trading in financial instruments or commodities (as defined in §1.1411-5(a)(2)) (trading activity), \$70,000 in loss from his sole proprietorship (which is not a trade or business described in §1.1411-5), and \$30,000 in trading activity expense deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of \$20,000. A makes an election under section 172(b)(3) to waive the carryback period for this net operating loss.

(ii) For purposes of section 1411, A's net investment income for Year 1 is the excess (if any) of the \$20,000 in gross income from the trading activity over the \$30,000 deduction for the trading activity expenses. Net investment income cannot be less than zero for a taxable year. Therefore, A's²² net investment income for Year 1 is \$0.

Verbatim from reg. 1.1411-4(h)

(iii) For Year 2, A has \$200,000 of wages, \$100,000 of gross income from the trading activity, \$80,000 of income from his sole proprietorship, and \$10,000 in trading activity expense deductions. For income tax purposes, A's \$20,000 net operating loss carryover from Year 1 will be allowed as a deduction. In addition, under section 1.1411-2(c), A's Year 1 \$20,000 net operating loss will be allowed as a deduction in computing A's Year 2 modified adjusted gross income.

(iv) For purposes of section 1411, A's \$20,000 net operating loss carryover from Year 1 is not allowed in computing A's Year 2 net investment income. As a result, A's Year 2 net investment income is \$90,000 (\$100,000 gross income from the trading activity minus the \$10,000 of trading activity expenses).

Interest and Dividends

Interest has a generally generic definition for purposes of the excise tax, and includes substitute payments (e.g., imputed amounts in a sale / repurchase arrangement).

Dividends also has a generally generic definition, and includes constructive dividends; e.g:

- Recharacterized purported salaries of S corporation shareholder / employees),
- Deemed dividends on exchanges of stock of foreign corporations (see regs. at 1.367(b)-2) and
- S corporation distributions out of C year E&P (see section 1368(c)(2)).

Substitute payments are also treated as dividends for purposes of the excise tax.

Annuities

Investment income includes amounts received as an annuity under an annuity, endowment or life insurance contract includible in gross income under section 72(a), (b) or (e), and the gain or loss on the sale of an annuity, endowment or insurance contract.

However, there is an exception for payments from retirement arrangements, even if they are paid as annuities. Net investment income does not include distributions from:

- Qualified pension, profit sharing or stock bonus plans,
- Qualified employee annuities,
- Section 403(b) so-called “school teachers” annuities,
- IRAs (including SEPs and SIMPLE IRAs) ,
- Roth IRAs or
- Section 457(b) deferred compensation arrangements.

Rents and Royalties

Royalties also has a generally generic definition (i.e., mineral, oil and gas, patents, copyrights, trademarks, franchises, etc.).

Rents are defined as amounts received principally for the use of or the right to use tangible property (note that this definition includes rentals of both real and personal property).

Passive Activities

For purposes of the excise tax, regulations define passive activity as trade or business in which the taxpayer is not a material participant under regulations at 1.469-5T.

- Under this definition, rentals generally are not treated as passive activities, but rents are specifically listed as items of investment income without regard to whether they are passive activities.

Rentals and Other Passive Activities

Regulations at 1.1411-5 draw a distinction between rental arrangements that are treated as nonpassive under section 469 regs. and arrangements that are specifically not treated as rents at all.

Nonpassive Rentals

For purposes of the excise tax, rents are treated as investment income regardless of whether they are treated as nonpassive for purposes of the passive activities rules. Regulations under section 469 list four circumstances under which Income (but not losses) from rental operations are treated as not passive:

- Reg. 1.469-9 (dealing with so-called real estate professionals),
- Reg. 1.469-2(f)(6) (rentals to activities in which the taxpayer is a material participant),
- Reg. 1.469-2T(f)(3) (rentals of property where less than 30% of its unadjusted basis is depreciable and
- Reg. 1.469-2T(f)(5) (certain rentals incidental to development activity).

Rents Grouped with Business Operations

Rentals properly grouped with trade or business under regs. at 1.469-4(d)(1) will not convert the rental income into income from a trade or business for purposes of section 1411 (see the last sentence of Part 6.B.i.(b)(4) of the preamble, NPRM REG 130507).

Self-Rentals

Self-rentals (described at reg. 1.469-2(f)(6)) may result in the worst of both worlds.

- They are not treated as passive; and, consequently cannot be offset by the taxpayer's passive losses, but they are still rents included in net investment income.
- In addition, self-rentals to a C corporation cannot be grouped with a trade or business under reg. 1.469-4(d)(1) because reg. 1.469-4(d)(5)(ii) prohibits the grouping of any activity carried on by a C corporation.

Self-Rentals

The *Veriha* Case

In *Veriha* 139 TC No. 3, rental income from a leasing operation substantially owned and controlled by the taxpayer was recharacterized as nonpassive under the self-rental rules at reg. 1.469-2(f)(6), while losses from another leasing operation 100% owned by the taxpayer were treated as passive.

- The taxpayer owned 100% of a C corporation engaged in a trucking business. He also owned 99% of an S corporation and all of a disregarded single member LLC that leased tractor–trailer rigs to his C corporation. Each tractor and each trailer was subject to a separate lease agreement.
- The S corporation passed net rental income through to the taxpayer. The single-member LLC had a net rental loss. The taxpayer treated both as passive and offset the losses from the LLC against the income from the S corporation.

The Tax Court ruled that each tractor and each trailer was a separate unit of property; consequently, the income from profitable rentals was properly recharacterized as nonpassive, and rentals generating losses were properly treated as passive.

The *Veriha* Case

Observations

Beginning in 2013, the (nonpassive) income from the profitable rentals will potentially be subject to the excise tax, while the (passive) losses from the unprofitable rentals carry over (recall that losses disallowed under section 469 are disallowed for other purposes as well).

- If the trucking business had been an S corporation (or another passthrough entity), the taxpayer could have treated all three operations as one activity (see, again, regs. at 1.469-4(d)(1).
 - The rents would still be treated as rents for purposes of the excise tax, but the taxpayer would have been able to offset his rental losses from the SMLLC against the rental income from the S corporation.

Nonrentals

Regs. at 1.469-1T(e)(3)(ii) list six exceptions to the rental rules:

1. The average period of customer is seven days or less,
2. The average period of customer use of the property is 30 days or less, and the owner provides significant personal services in connection with making the property available for use by customers,
3. The owner provides extraordinary personal services in connection with making the property available for use by customers,
4. The rental is treated as incidental to one of the taxpayer's nonrental activities,
5. The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers and
6. The taxpayer provides the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

Operations that meet one of these exceptions are treated as trade or business both under section 469 and for purposes of the excise tax.

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- In that case, the question is whether the taxpayer is a material participant in the activity.

Grouping Rules

Separate trade or business operations (but, again, not rents) properly treated as a single activity under regs. at 1.469-4 are treated as a single activity for purposes of the excise tax.

Verbatim from reg. 1.1411-5(b)(2)

Example 2. Application of grouping rules under section 469. In Year 1, A, an unmarried individual, owns an interest in PRS, a partnership for Federal income tax purposes. PRS is engaged in two activities, X and Y, which constitute trades or businesses (within the meaning of section 162), and neither of which constitute trading in financial instruments or commodities (within the meaning of paragraph (a)(2) of this section). Pursuant to §1.469-4, A has properly grouped X and Y (the grouped activity). A participates in X for more than 500 hours during Year 1 and would be treated as materially participating in the activity within the meaning of §1.469-5T(a)(1). A only participates in Y for 50 hours during Year 1, and, but for the grouping of the two activities together, A would not be treated as materially participating in Y within the meaning of §1.469-5T(a). However, pursuant to §§1.469-4 and 1.469-5T(a)(1), A materially participates in the grouped activity, and therefore, for purposes of paragraph (b)(1)(ii) of this section, neither X nor Y is a passive activity with respect to A. Accordingly, with respect to A, neither X nor Y is a trade or business described in paragraph (b)(1) of this section.

Regrouping Opportunity

Reg. 1.469-11(b)(3)(iv)(A) allows individuals, estates and trusts affected by section 1411 a one-time opportunity to regroup activities for any year that begins during calendar 2013. The regrouping must comply with the requirements of reg. 1.469-4 and Rev. Proc. 2010-13 and will be effective for all subsequent years.

- Regrouping may allow a taxpayer to eliminate passive income by allowing him or her to qualify as a material participant in the expanded activity. However, as noted above, a proper grouping or regrouping of rents with trade or business will not convert the rental income to income from trade or business.

Portfolio Income

Portfolio income not derived in the ordinary course of a trade or business is not treated as passive income under section 469, but it is investment income under section 1411. Contrast Example 3, reg. 1.1411-4(b) with Example 5 from reg. 1.1411-5 (b)(2):

Example 3, reg. 1.1411-4(b)

Example 3. Application of ordinary course of a trade or business exception. C, an individual, owns stock in S corporation, S. S is engaged in a banking trade or business (that is not a trade or business of trading in financial instruments or commodities), and S's trade or business is not a passive activity (within the meaning of section 469) with respect to C. S earns \$100,000 of interest in the ordinary course of its trade or business, of which \$5,000 is C's pro rata share. Because S is not engaged in a trade or business described in §1.1411-5(a)(2) and because S's trade or business is not a passive activity with respect to C (as described in §1.1411-5(a)(1)), the ordinary course of a trade or business exception described in paragraph (b) of this section applies, and C's \$5,000 of interest is not included under paragraph (a)(1)(i) of this section.

Example 5 from reg. 1.1411-5(b)(2)

Example 5. Application of the portfolio income rule and section 469. C, an unmarried individual, is a partner in PRS, a partnership engaged in a trade or business (within the meaning of section 162) that does not involve a rental activity. C does not materially participate in PRS within the meaning of §1.469-5T(a), and therefore the trade or business of PRS is a passive activity with respect to C for purposes of paragraph (a)(1) of this section. C's \$500,000 allocable share of PRS's income consists of \$450,000 of gross income from a trade or business and \$50,000 of gross income from dividends and interest (within the meaning of §1.1411-4(a)(1)(i)) that is not derived in the ordinary course of the trade or business of PRS. Thus, under section 469(e)(1)(A)(i)(I) and the regulations thereunder, C's allocable share of gross income from dividends and interest consists of portfolio income. Therefore, C's \$500,000 allocable share of PRS's income is subject to section 1411. C's \$50,000 allocable share of PRS's income from dividends and interest is subject to §1.1411-4(a)(1)(i) because the share is gross income from dividends and interest that is not derived in the ordinary course of a trade or business (that is, the ordinary course of a trade or business exception in §1.1411-4(b) is inapplicable). C's \$450,000 allocable share of PRS's income is subject to §1.1411-4(a)(1)(ii) because it is gross income from a trade or business that is a passive activity.

Traders in Securities or Commodities

Income and losses of traders in securities or commodities (including gain or loss on deemed sales under the mark-to-market election at section 475(f)) are treated as investment income.

- The determination of whether an activity consists of trading in securities or commodities is made at the entity level. Consequently, in cases involving passthrough entities, an individual member's activity (or lack thereof) is moot.

Verbatim from reg. 1.1411-4(b)

Example 2. Entity engaged in trading in financial instruments. B, an individual, owns an interest in PRS, a partnership, which is engaged in a trade or business of trading in financial instruments (as defined in §1.1411-5(a)(2)). PRS' trade or business is not a passive activity (within the meaning of section 469) with respect to B. In addition, B is not directly engaged in a trade or business of trading in financial instruments or commodities. PRS earns interest of \$50,000, and B's distributive share of the interest is \$25,000. Because PRS is engaged in a trade or business described in §1.1411-5(a)(2), the ordinary course of a trade or business exception described in paragraph (b) of this section does not apply, and B's \$25,000 distributive share of the interest is net investment income under paragraph (a)(1)(i) of this section.

Exception for SE Income

Net investment income does not include any amount taken into account for purposes of determining the amount of the taxpayer's self-employment income. Amounts specifically excluded from the definition of SE income (see section 1402(a)(1) through (17)) are disregarded for this purpose.

- It is possible for taxpayer to have passive income from a trade or business activity (i.e., where the taxpayer is not a material participant) that is subject to the SE tax (see the definition at section 1402(a) and note that there are no exceptions for passive activities).
 - Income from a passive activity subject to the SE tax is apparently not included in net investment income. See the exclusive language in the first sentence of reg. 1.1411-9(a). Paragraph (b) deals with traders in securities or commodities

Reg. 1.1411-9(a), First Sentence Exception for Self-Employment Income Verbatim

(a) General rule.—Except as provided in paragraph (b) of this section, net investment income (as defined in §1.1411-4) does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year.

Gain or Loss on the Disposition of Property not Used in a Trade or Business.

Recognized gains or losses on the disposition or deemed disposition of property not used in a trade or business are treated as investment income for purposes of the excise tax.

- Some Examples:
 - Gain or loss on the disposition of rental property,
 - Taxable gain on the sale of a principal residence and
 - A non-trader's gain or loss under mark-to-market rules at section 1256)

Look-Through Rule for Dispositions of S Corporation Stock or Partnership Interests

For purposes of determining the taxpayer's net investment income, the sale or exchange of S corporation stock or an interest in a partnership is treated as a sale of the taxpayer's proportionate share of each of the entity's assets.

- Allocations of gain or are loss are made with respect to any rule that would apply to an actual sale (e.g., sections 704(b), 704(c)(1)(A), 743, etc.), except for the built-in-gain tax on S corporations.
- These rules also apply in cases where a partner or S shareholder recognizes gain on account of a distribution in excess of basis under section 731(a) or 1368(b).

Look-Through Rule for Dispositions of S Corporation Stock or Partnership Interests

Reporting Requirements

- The taxpayer must attach a plain-paper statement to his or her return for the year of the disposition distribution identifying:
 - The interest disposed of,
 - Detailing the computation of his or her taxpayer's share of gain or loss as to each of the entity's properties and
 - A statement as to whether the property was held in a trade or business other than a passive activity, or by a securities or commodities trader.