Understanding the Net Investment Income Tax, also known as the Medicare Contribution Tax

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In brief

The Patient Protection and Affordable Care Act and The Health Care and Education Reconciliation Act of 2010 created two new stand alone tax regimes for higher income taxpayers effective for 2013. One tax applies to net investment income and the other applies to wages and self-employment income. The legislation itself was very general and it was up to the Internal Revenue Service (IRS) to come up with a workable set of regulations. The IRS released proposed regulations in late November 2012. Many practitioners expected that new forms and revised forms would be required to report these new taxes. The proposed regulations reinforce this expectation.

The more complex regime is a 3.8% tax on various types of investment income received by individuals, trusts and estates (unearned income). This Net Investment Income Tax or NIIT (sometimes called the Medicare Contribution Tax), will be applied to net investment income in excess of certain thresholds.

The other regime represents a 0.9% tax added to the Medicare tax currently applied to earned income, i.e. employee compensation and self-employed earnings. This surtax increases the existing 1.45% employee Medicare tax to 2.35% and the 2.9% self-employed Medicare tax to 3.8% on compensation or self-employment income above certain thresholds. This tax is imposed on the employee and will have withholding and reporting requirements for employers.

Almost 160 pages long, the proposed regulations, preamble, and Q&A materials provide much needed guidance on how the tax base is calculated, including the types of income and deductions that are part of the NIIT tax calculation, as well as more complex issues such as the calculation of gain from the sale of partnership or S corporation interests. Finally, the interplay of income from controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs) is also examined with some interesting results. The proposed regulations discuss and describe the levels of information that will be necessary to calculate the tax. The collection and distribution of additional information associated with pass through entities will be significant.

The proposed regulations are effective for the 2014 income tax return but can be applied to the 2013 filing. The new tax will be part of the tax payment requirements for 2013, i.e., estimated tax payments.

In detail

The purpose of this executive summary is to explain the general workings of the NIIT including the categories of income subject to NIIT, the types of income not subject to the NIIT, and the deductions available against NIIT.

Overview

Net investment income is gross investment income less deductions allocable to that income. Investment income comes from three categories. The first category is traditional portfolio income such as interest, dividends, annuity income, royalties, and certain types of rental activities. The second category of investment income includes trade or business income from 'passive investments' as well as income from trading in financial instruments. This category makes reference to the passive activity rules. The final category of investment income is gains from disposition of property including capital gain from portfolio investments and capital gain from sales of 'passive activities'. Capital gain from the sale of a primary residence is only subject to NIIT if the gain on sale exceeds the existing exclusion.

After combining income from the three categories (losses from one category do not reduce income from another category) certain deductions are allowed to arrive at 'Net Investment Income.'

The 3.8% tax then applies to the lesser of (1) net investment income or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount. Note that the threshold level is BEFORE itemized deductions. Further the NIIT applies to individuals who might not be in the maximum income tax bracket.

The threshold amount for single taxpayers is $200,000 and for married taxpayers filing jointly is $250,000. For married individuals filing separately, the threshold is $125,000. The threshold for trusts is $11,950 (the income level at which the maximum income tax rate begins).

Example — Bill is single ($200,000 NIIT threshold). He has wage income of $185,000 and interest income of $25,000. He has no itemized deductions. His modified adjusted gross income is $210,000. He is subject to NIIT on $10,000 — the lesser of net investment income ($25,000) or income above the threshold ($10,000).

Example — Mike is single ($200,000 NIIT threshold). His wage income is $500,000 and he has $35,000 of interest and dividend income. He has no itemized deductions. Mike's modified adjusted gross income is $535,000. He is subject to NIIT on $35,000 — the lesser of net investment income ($35,000) or income above the threshold ($335,000).

Certain types of income are excluded from the definition of net investment income:

- earned income — wages and self-employment income (subject to the 0.9% Medicare supplement tax)
- so called active trade or business income
- distributions from qualified retirement plans or IRAs
- interest on municipal bonds
- excludable portion of gain on primary residence sale.

Note that while earned income, active business income, and retirement plan distributions are not subject to NIIT they do increase adjusted gross income (increasing the likelihood that the tax will apply).

The active trade or business income exclusion does not apply to 'income, gain, or loss on working capital,' which is characterized as net investment income. The IRS regulations make it clear that portfolio type income passing through partnerships and S corporations retains it character as portfolio income.

The categories of income

The regulations discuss the three different categories of investment income in separate sections and state that losses in one category are not allowed to offset income or gain in another category. In particular the disposition of passive activities and the release of suspended passive activity losses is mentioned as a topic for future guidance. There are some types of investments that straddle different categories.

Portfolio income

The proposed regulations simply repeat the different income types included in the original legislation. Greater clarity is provided in the preamble to the proposed regulations.

Interest and dividend income includes substitute interest or dividends, constructive dividends, distributions from previously taxed earnings and profits and certain excess distributions from passive foreign investment companies (PFICs). The inclusion of income and dividends from a foreign entity (controlled foreign corporations or passive foreign investment companies) in net investment income has special record keeping and election aspects.

Notional principal contract income is not considered investment income unless it is associated with the trading of financial instruments or commodities. This sets up a distinction between notional principal contracts (often part of hedging or swap strategies) that are entered into as an investor compared to contracts entered into by a trader in financial instruments. The expenses associated with investor contracts would be a miscellaneous itemized deduction rather than a trade or business expense. Note that the gain from the disposition of a notional principal contract is subject to NIIT even for an investor.

Annuity income includes payments from an annuity, endowment, or life insurance contract that is otherwise included in income under Internal Revenue Code Section 72. The annuity exclusion and basis recovery rules would first be applied to determine the amount included in income.

Royalty income includes mineral, oil and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property.

Rental income is a complex topic that has the potential to straddle categories. Rental income which is not conducted as a regular trade or business is included in the first category of portfolio type income. However, rental income conducted as a trade or business is part of the second category of investment income (where the individual or trust is subject to the passive activity rules—see below). The proposed regulations spend some time discussing the difference between rental activities that are not a trade or business and rental activities that are a trade or business without providing any practical examples. The proposed regulations reference cases and rulings that guide this determination. This reference is to a series of court cases and private letter rulings in the years before the passive activity loss rules (pre 1987) where the IRS sometimes took contradictory positions. The court cases treated most rental property as a trade or business for income tax purposes while the IRS refused to respect that treatment for estate tax related special valuation and installment payment. Rental real estate subject to a triple net lease would be an example of rental income that would not be a trade or business activity.

Income from Passive Foreign Investment Companies (PFICs) is investment income but only when actually distributed according to the proposed regulations. The current recognition of income from a Qualified Electing Fund (QEF) does not apply for the calculation of Net Investment Income (absent a special election). This creates a potential timing difference for those investors that have made the QEF election for regular income tax purposes. This would result in income being reported earlier for income tax purposes than for NIIT purposes. The proposed regulations create a special NIIT QEF election so individuals need not separately track PFIC activity (income that is reported for regular income tax purposes compared to income that is reported for NIIT purposes). This special NIIT election is made at the individual level and would apply to all the individual's PFICs. This means that pass through entities such as partnerships and S corporations must furnish both types of reporting information to their individual investors. Similar rules apply to controlled foreign corporations (CFCs).

Income from Section 529 Qualified Tuition Plans not used for education purposes is not subject to NIIT. This is specifically addressed in the preamble to the regulations. However, such distributions may be subject to a 10% excise tax (and would increase adjusted gross income).

Not addressed in the preamble or regulations is the treatment of income from currency transactions that are not associated with a trade or business, lottery/gambling winnings, foreign pension plan payments, or foreign government plan payments.

Trade or business income

The second category of income includes either trade or business income from 'passive activities' or income from the business of trading in financial instruments or commodities. This category would include business income reported on Schedule C, Schedule E, or Schedule F of an individual or trust tax return. Business income would include businesses organized as sole proprietors, entities that are treated as partnerships (such as LLCs) and S Corporations.

Earnings from pass-through entities such as partnerships, LLCs, and S corporations are reported on Schedule K-1 and are broken into component parts (aka separately stated items). Different lines on the Schedule K-1 are earmarked for business activity income while others are earmarked for investment related income. The Schedule K-1 lines that report interest, dividends, or other portfolio income retain their character for NIIT (as portfolio income discussed above). The Schedule K-1 lines related to trade or business activity also retain their character.

Business income from a 'passive activity' is subject to NIIT. The determination of whether a business activity is 'passive' or 'active' (more correctly referred to as 'material participation') requires a journey into the complex passive activity loss regulations and is made at the individual or trust level. Thus, pass through entities will be under more pressure to provide details about business operations so the individual or trust can correctly determine the treatment of income from that trade or business. This level of detail will be even more important for layered or tiered structures with multiple business activities.

The new importance of 'passive activity' will turn the entire passive versus material participation categorization upside down. Historically, 'passive' activity treatment was a desirable result for income producing businesses. No longer is that necessarily the case. Taxpayers will now be seeking ways to meet the material participation standards and have the activity classified as a material participation trade or business (not subject to NIIT).

The passive activity regulations have extensive rules and definitions that will be critical in determining NIIT application. The passive activity regulations require that the taxpayer group 'undertakings' into activities based on a series of guidelines. The activity is then tested for material participation. There are seven different material participation tests. The most common test is a 500 hour test (does the individual spend 500 or more hours at the activity). The grouping of undertakings and activities is a critical part of meeting the material participation standard. Special rules apply to real estate professionals and real estate rented to a related material participation business (although the proposed regulations suggest that real estate rented to a related material participation business may not be a trade or business activity). A detailed discussion of the material participation rules is beyond the scope of this executive summary. It is important to note that activities may be passive some years and not passive in other years. The determination is made at the individual or trust level at the end of the year based on the level of participation during the year.

Normally, activity grouping cannot be changed without IRS permission (absent a change in facts and circumstances). However, the IRS recognizes that the NIIT casts new importance on correctly grouping undertakings and activities. The proposed regulations permit a 'fresh start' regrouping for NIIT calculation purposes beginning in 2014 (or 2013 if the NIIT applies).

Business income from activities that are classified as 'material participation' are NOT subject to NIIT (although portfolio income from the business will be subject to NIIT).

A practical problem associated with trade or business activity is the need to make estimated tax payments of NIIT during the year. Taxpayer's will be forced to make a tentative determination about 'passive activities' for estimated tax purposes even though the determination cannot be made until the year is over. Taxpayer's may deliberately over pay NIIT estimated amounts to avoid penalty (for those who are using current year tax as the target rather than 110% of prior year tax).

Trust owners of business activities have a special issue to deal with in determining passive activity status. Generally, the activities of the trustee are examined to determine passive status, but there is a court case that suggests that agents, employees, and beneficiary activity may also be considered.

Business income from trading in financial instruments or commodities is not subject to the passive activity rules. Instead it is all subject to NIIT as a specific sub-set of trade or business activity. This type of activity has the potential to straddle categories.

The determination of whether the entity is engaged in 'the business of trading in financial instruments or commodities' is made at the entity level. The determination of 'trader' status and any resulting elections are important determinations that are beyond the scope of this executive summary. The proposed regulations have an extensive description of the income and deductions that are usually associated with trading in financial instruments or commodities.

Gains from disposition of property

The final category of income subject to NIIT is gain from the disposition of property (other than property held in a trade or business). This would include gain on the sale of stocks, bonds, mutual funds, and second residences. Sales of rental property are subject to NIIT if the rental activity was a passive activity or not part of a trade or business. Taxable gain from the sale of a primary residence (after applicable gain exclusions) is also subject to NIIT. Distributions from partnerships or S corporations in excess of basis are subject to NIIT. Finally, dispositions of notional principal contracts fall into this category.

Gain from the disposition of an interest in a partnership or S corporation presents a particular problem because the NIIT does not apply to gains associated with a material participation trade or business. The proposed regulations recognize this distinction and require that the sale of an interest in a partnership or S corporation be treated as if the owner had sold all the assets of the business (a look through test). Each asset of the business must be examined separately to determine if it was used in the material participation trade or business. The sale of assets used in the business activity where the taxpayer materially participates would be exempt from

NIIT. Assets owned by the business but not used in the trade or business activity would be subject to NIIT.

Obviously the categorization of assets within the partnership and determining which assets are business assets and which assets are unrelated to the business will be an area of concern. The proposed regulations contain an extensive discussion of the complex determinations and calculations involved when a business is sold. A discussion of this look through determination is beyond the scope of this executive summary.

Mark-to-market gains associated with swaps (notional principal contracts) are not treated as a disposition of property. Such gains would not be subject to NIIT for investors. However, mark-to-market gains associated with trader activities would be subject to NIIT as part of trade or business income.

Not addressed in the proposed regulations is how to treat current year gain from prior year installment sales. The regulations discuss installment sales of partnership and S corporation interests but not other types of installment sales (such as real estate).

Multiple category income

While the legislation and proposed regulations neatly organize income into three categories, there are several types of income that straddle the categories. Ongoing **rental activities** can fall into either category one (portfolio income) or category two (trade or business) while the sale of the property will be captured in category three (gains from disposition of property). The discussion of rental income that is not a trade or business in the proposed regulations is likely to create differences in interpretation. **Investment and trader partnerships** will have to be especially careful about income and deduction categorization.

The IRS has specifically requested comments on the disposition of a passive activity. Passive activity disposition will often 'release' suspended trade or business losses (category two income) as well as capital gain resulting from depreciation recapture (category three income).

Deductions from investment income

The proposed regulations provide that the following deductions may be used to offset investment income:

- investment interest expense
- investment expenses
- expenses attributable to rents and royalties
- penalties for early withdrawal of savings
- allocable state and local income taxes.

It should be noted that these deductions are only allowed to the extent that they are deductible when calculating ordinary income for regular income tax purposes. This means that the investment interest limits would be applied to determine the deductible amount of investment interest. Other investment related expenses (investment management fees and expenses for the production of income) would be subject to the 2% floor on miscellaneous itemized deductions before being used against investment income.

The phase-out of itemized deductions must be apportioned across all deductions subject to phase-out before they can be applied against investment income. This is a departure from the 'with and without' method often used with tax calculations. The pro-rata method may be easier to calculate. Note that investment interest expense is not subject to the itemized deduction phase-out.

Finally, the proposed regulations comment that any reasonable method can be used to apportion state and local income tax against investment income. Collectively, these deductions cannot reduce net investment income below zero and cannot be carried over for NIIT purposes. Normal income tax rules associated with investment interest expense carryover will apply for NIIT purposes.

Net operating losses may not be used to offset investment income.

Credits

Neither the legislation nor the proposed regulations discuss credits against the NIIT. This would be of particular interest to individuals and trusts with foreign source investment income.

Individuals and trusts – Special rules

Only individuals, trusts, and estates are subject to the NIIT. However, there are some special individual situations that are addressed in the proposed regulations. Likewise there are a number of special rules that apply to trusts. Trust owners of partnerships and S corporations must pay special attention to how the passive activity loss rules apply to them.

Individuals

NIIT applies to US citizens or residents. The tax does not apply to non-resident aliens and residents of certain US territories. A unique situation arises when a US resident has a non-resident alien spouse. The proposed regulations note that the non-resident alien spouse is not subject to NIIT unless the couple makes an election to subject the non-resident alien spouse to US income tax. This election is then effective for NIIT purposes as well.

The NIIT threshold amounts for individuals are $250,000 for a joint return, $200,000 for a single taxpayer, and $125,000 for a married couple filing separately. The threshold amounts will be prorated for an individual with a short tax year due to an accounting period change. However, the threshold amount is NOT prorated for an individual who dies during the year. Note that the maximum income tax rates begin at different dollar thresholds and the threshold for income tax rates is taxable income and not modified adjusted gross income.

The Q&A provided by the IRS points out that a child's investment income included on the parents return, the so-called 'kiddie tax' election, will be subject to the NIIT.

Estates and trusts

The taxation of trusts and estates depends on the type of trust and whether the trust income is distributed or retained by the trust. To the extent the trust or estate retains the income it will be subject to NIIT at the trust level. Income distributed to beneficiaries may be subject to NIIT on the beneficiary's personal tax return. The NIIT threshold for income retained by the trust or estate is $11,950 (the income level at which the maximum tax bracket begins). The threshold amount is reduced if the trust or estate has a short taxable year resulting from the formation or termination of the trust or estate.

Trusts generally maintain two parallel sets of books. One set of records represents general accounting rules that separate receipts into principal or income. This distinction is important for the beneficiaries of the trust since some beneficiaries may only be entitled to income while others are entitled to principal. This set of records is based on state law concerning trust operations (so called principal and income statutes). The second set of records is for income tax purposes and determines whether the trust pays income tax on the receipts or whether it is passed to the beneficiary and subject to tax on the beneficiary's personal return.

The NIIT creates a third set of records and requires that trusts now track Net Investment Income and determine if Net Investment Income has been retained by the trust or distributed to the beneficiary. If Net Investment Income is distributed to the beneficiary then the trustee must provide the beneficiary with regular income tax data and NIIT data.

The NIIT applies to pooled income funds, cemetery perpetual care funds, qualified funeral trusts, and certain Alaska Native settlement trusts. The IRS has requested comments about the application of NIIT to these entities.

Special trust and estate rules

There are a number of special types of trusts with their own set of rules

A grantor trust is a disregarded entity for income tax purposes. Trust income is reported directly on the 'grantor's' personal tax return. The proposed regulations note that the NIIT applies only at the individual income tax return of the grantor. The trust is not subject to NIIT (since it is ignored for tax purposes).

A bankruptcy estate is simply a special way to calculate income tax for those in bankruptcy. A bankruptcy estate is treated in the same manner as a married person filing separately. The proposed regulations note that the NIIT threshold is $125,000 for a bankruptcy estate.

An Electing Small Business Trust (ESBT) is a trust that owns shares in an S corporation. Special rules apply to calculate income tax associated with S corporation income. Regular trust tax rules apply to income from other assets (if any). In effect the trust is bifurcated into two 'portions' for regular income tax purposes with different rules applied to each portion. The proposed NIIT regulations require that the two portions be aggregated in determining the threshold for NIIT purposes.

A charitable remainder trust pays income to a beneficiary for a period of time and then the assets are transferred to charity. The trust itself pays no income tax. Instead the beneficiary is subject to income tax on distributions based on a complex tier system that tracks both current year income as well as prior year undistributed income and gain. The proposed regulations add a new NIIT recordkeeping requirement on the trust. The charitable remainder trust must also track income and gain earned after 12/31/12 and report distributions subject to NIIT to the beneficiary each year. The proposed regulations make it clear that accumulated income and gain as of 12/31/2012 will not be subject to NIIT when received by the beneficiary. Unfortunately, pre-2013 accumulated income and gain (not subject to NIIT) are distributed only after post-2012 income and gain (subject to NIIT) has been exhausted.

Foreign trusts and estates are not subject to NIIT or any US income tax. However, the beneficiary of a foreign trust or estate has a special calculation that is applied to distributions for regular income tax purposes. The proposed regulations specifically do not address the application of NIIT to a US beneficiary of a foreign trust or estate. The IRS has requested comments on the application of NIIT to foreign trusts and estates with US beneficiaries. Likewise, the IRS has requested comments on whether foreign pension funds that are treated as trusts for US purposes should also be excluded from NIIT.

Earned income Medicare surtax

Currently the Medicare tax is 2.9% of all earned income. Employees pay 1.45% of this tax and employers pay 1.45% of the tax. Self-employed individuals pay the entire 2.9% but receive an income tax deduction for 1/2 of the tax.

Beginning in 2013 the employee portion of this tax will be increased by 0.9% for high income taxpayers. The surtax applies to earned income over $200,000 for single individuals and $250,000 for married couples filing a joint tax return. Note that the thresholds only apply to earned income and not modified adjusted gross income. The surtax also applies to self-employment earnings. The deduction for self-employment taxes is not increased by the .9% surtax.

Payroll providers must be alert for wages over the thresholds and begin to collect the surtax. Employees with multiple jobs and working couples create additional complexity. The proposed regulations did not deal with the Earned Income Medicare Surtax.

The takeaway

The Net Investment Income Tax is a complex stand alone tax. The legislation did not provide definitions or terminology. The proposed regulations specifically point out areas where the NIIT terminology is likely to vary from traditional income tax terminology.

Even though the proposed regulations mark a significant step, the complexity of the topics and the need to make subtle distinctions for record keeping and compliance will foster challenges for taxpayers, tax practitioners, and the IRS for years to come.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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