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<u>Unearned Income Medicare Contribution Tax: Net Investment Income Tax</u>

Legislated as part of the Health Care and Education Reconciliation Act of 2010, the companion to the Patient Protection and Affordable Care Act of 2010 (or ObamaCare), the Unearned Income Medicare Contribution Tax imposes on individuals (as well as estates and trusts, not discussed here) a 3.8% surtax on net investment income (the "Net Investment Income Tax" or "Surtax"). The Net Investment Income Tax is a true surtax because it is levied on top of an individual's ordinary income or capital gains taxes, as applicable. It is not, however, a source of revenue to fund Medicare as is pointed out by the Joint Committee on Taxation: "No provision is made for the transfer of the tax imposed by this provision from the General Fund of the United States Treasury to any Trust Fund." The Internal Revenue Service cut to the chase and used the phrase Net Investment Income Tax on its Form 8960 (when the draft becomes final).

For individuals, the Surtax is imposed on the lesser of (1) "net investment income" for the tax year, or (2) the amount by which the modified adjusted gross income ("MAGI") exceeds the "threshold amount." The threshold amounts are $200,000 (for single filers), $250,000 (for married filing jointly) and $125,000 (for married filing separately), and they are <u>not</u> indexed for inflation.

Net investment income falls into three categories and is reduced by allocable deductions. The first category is interest, dividends, annuities, royalties and rents (other than rents received as part of a trade or business). The second category consists of income derived from a trade or business that is passive income, or income from a business trading financial instruments or commodities. The final category is net capital gains (except gains on property held in a trade or business). Deductions that reduce net investment income include deductions relating to producing rental, royalty and business income as well as the portion of state income tax that relates to the net investment income.

Each category of net investment income has exceptions; some are very broad while others are extremely narrow. For example, taxable interest is not included in net investment income if (1) the interest is earned in a "trade or business"; (2) the interest is earned in the "ordinary course of a trade or business"; (3) the trade or business is not the trading of financial instruments or commodities; <u>and</u> (4) the taxpayer is not a "passive" investor in the trade or business. The phrase "scare quotes" was never so appropriate. In all of the volumes that constitute the Internal Revenue Code of 1986 (the "Code") and Treasury regulations promulgated under the Code, nowhere is the phrase "trade or business" defined, but whether income is earned in a "trade or business" is the starting point of whether or not the income is included in net investment income for purposes of the Surtax.

Now with a general understanding of the rules, let's examine a couple of examples of the applicability of the Surtax as well as some ways to potentially mitigate its impact.

<u>Example A</u>. Mr. and Mrs. Taxpayer have $350,000 of salary income and file jointly, but have no net investment income. The Surtax does not apply because there is no net investment income.

Example B. Same as Example A, except that salary income is reduced to $200,000 and the Taxpayers have $150,000 of net investment income. The Surtax would apply to $100,000 because it is the lesser of the net investment income ($150,000) or the excess of MAGI ($350,000) over the threshold amount ($250,000).

Example A provides the simplest way around the Surtax – earn no net investment income. However, given the broad designs established by the three categories (and assuming MAGI in the tax year exceeds the applicable threshold amount), more sound strategies are necessary. One strategy is to lower annual income through deferral, including maximizing qualified retirement plan contributions. (Additional benefit: net investment income does not include any distribution from a qualified retirement plan or arrangement.) Another option: income from municipal bonds is not considered net investment income, so the net after-tax effect of such assets should now take into account the savings from avoiding the Surtax. The Surtax should also be considered when determining the after-tax cost of wealth transfers and charitable giving, because they too will mitigate the sting of the Surtax.

The Surtax was envisioned as a simple, straightforward flat tax assessed on passive-type income. Practitioners comment that the IRS has made a complex statute, Section 1411 of the Code, even more complex with 130 pages of preambles and regulations. Simple, straightforward and flat do not fit together in the world of tax, perhaps for the same reason that the "Unearned Income Medicare Contribution Tax" is not actually a funding mechanism for Medicare.

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This issue of the Tax Law Alert was written by Christopher J. Rixon, Chair of the Tax Group at Reid and Riege, P.C. The Group works with business lawyers on issues of choices of entities, formation and operation, as well as taxable and/or tax-free transactions. The Group is involved with decisions involving capitalization, working with commercial and transactional lawyers in structuring and determining levels of equity, debt and various hybrids. The Tax Group is also called upon to work outside the Business Law Practice Area with respect to issues of pensions and profit sharing arrangements, trusts and estates, personal wealth planning, real estate transactions and financing, litigation and settlement agreements, health care and nonprofit law.

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