PART III: INVESTMENT INCOME TAX AND ADDITIONAL MEDICARE TAX

8577. What is the net investment income tax?

The investment income tax is surtax of 3.8 percent in addition to the regular income tax that certain high income taxpayers would otherwise owe on such income. The tax is imposed on the *lesser* of the following amounts:

(1) Net investment income (see Q 8579 for an explanation of what amounts are included in net investment income); or

(2) The excess (if any) of (i) the taxpayer's modified adjusted gross income (MAGI) (as explained in Q 8578, below, for most taxpayers MAGI is actually AGI) for the year over (ii) the applicable threshold amount.[1]

The applicable threshold amount for single taxpayers is $200,000. For married taxpayers filing a joint return, the applicable threshold amount is $250,000 (see Q 8580 for a detailed discussion of who is liable for the investment income tax).

> *Example*: In 2014, Erica and Mickey a married couple filing jointly have an AGI of $400,000 including net investment income of $125,000. The applicable threshold amount for a married couple filing jointly is $250,000.
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> Applying the formula, the 3.8 percent net investment tax is imposed on the lesser of:
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> 1. Net investment income of $125,000; or
> 2. The excess of (i) AGI of $400,000 over (ii) the applicable threshold amount of $250,000, or $150,000.

Because the lesser of the two amounts is the $125,000 of net investment income, the 3.8 percent net investment income tax is imposed on the entire amount of net investment income.

> *Example*: Assume in 2015, Erica and Mickey have AGI of $300,000 including net investment income of $125,000 (the same amount as it 2014).
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> Applying the formula, the 3.8 percent net investment tax is imposed on the lesser of:
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> 1. Net investment income of $125,000; or
> 2. The excess of (i) AGI of $300,000 over (ii) the applicable threshold amount of $250,000, or $50,000.

In this case, the lesser of the two amounts is the excess of AGI over the applicable threshold amount. Thus, in spite of having net investment income of $125,000, only $50,000 is subject to the 3.8 percent net investment income tax.

Finally, certain trusts and estates are also subject to the net investment income tax (see Q 8595).

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1. IRC Sec. 1411(a)(1).

8578. What is modified adjusted gross income for purposes of the investment income tax?

For most taxpayers, MAGI is the same as their AGI. This is because the only adjustments made to AGI in arriving at MAGI relate to foreign earned income. Specifically, in arriving at MAGI, AGI is increased by the excess of (1) any amounts excluded under IRC 911(a)(1) (foreign earned income) over (2) the amount of deductions and exclusions disallowed under IRC 911(d)(6) (which disallows certain deductions and exclusions that would otherwise be properly allocable to an amount excluded from gross income because it is foreign earned income).[1] Thus, absent any foreign earned income, AGI and MAGI are the same amount.

8579. What is net investment income?

Net investment income is the tax base for the 3.8 percent net investment income tax (See Q 8577 for a discussion of the computation of the tax). In general, net investment income potentially includes any income other than "earned" income that is subject to social security tax and Medicare tax. Basically, there are 3 categories of net investment income. Pursuant to IRC Section 1411(c)(1), subject to exceptions discussed in Q 8588, the 3 categories of investment income are:

(a) income commonly considered to be traditional investment type income i.e., interest, dividends, annuities, rents and royalties;

(b) gross income derived from a trade or business; and

(c) net gain attributable to the disposition of property.[2]

8580. Who is liable for paying the investment tax?

Any taxpayer who has net investment income and modified adjusted gross income (MAGI) in excess of the applicable threshold amount is subject to the 3.8 percent net investment income tax. The applicable thresholds are MAGI in excess of $200,000 for single taxpayers, $125,000 for married taxpayers filing separately and $250,000 for married couples filing jointly. Unlike many other income threshold amounts, these thresholds are not indexed annually for inflation.[3]

In addition to individuals, the net investment income tax applies to certain trusts and estates (see Q 8595).[4] Nonresident aliens are not subject to the tax.[5]

8581. Are distributions from retirement accounts and qualified plans included in net investment income?

No. Although distributions from qualified plans often include earnings generated by traditional investment income, i.e., dividends and interests, distributions from qualified retirement

1. IRC Sec. 1411(d).
2. IRC Sec. 1411(c)(1)(A).
3. See Preamble to notice of proposed rulemaking, REG-130507-11, 77 Fed. Reg. 72611, 72615.
4. IRC Sec. 1411(a).
5. IRC Sec. 1411(e).

plans are not included in net investment income and thus are not subject to the net investment income tax.[1] This includes distributions from qualified plans pursuant to:

(1) IRC Section 401(a) (qualified pension, stock bonus or profit-sharing plans);

(2) IRC Section 403(a) (qualified annuity plans);

(3) IRC Section 403(b) (tax-sheltered annuities);

(4) IRC Section 408 (individual retirement accounts);

(5) IRC Section 408A (Roth IRAs); and

(6) IRC Section 457(b) (deferred compensation plans of state and local governments or tax-exempt organizations).

Deemed distributions under IRC Section 72(p) (loans from a qualified employer plan) are also excluded under this rule.[2] Additionally, amounts distributed from a qualified plan to purchase life insurance by the plan participant are not included in net investment income.[3]

8582. If a taxpayer converts a traditional IRA to a Roth IRA, does a taxable distribution take place that would subject the converted funds to the investment income tax?

In addition to actual retirement plan distributions (See Q 8581) that are excluded from net investment income, the final regulations also make it clear that deemed distributions from retirement plans are also excluded. For example, a rollover of funds from a traditional IRA into a Roth IRA never actually received by the taxpayer is nonetheless treated as a distribution for income tax purposes. Similar to actual retirement distributions, the IRA/Roth conversion deemed distribution is excluded from net investment income; and, thus, is not subject to the net investment income tax.[4]

8583. How do the net investment income rules apply to amounts received under an annuity contract?

Income from annuities included in gross income pursuant to IRC Sections 72(a) and 72(b) are also included in net investment income pursuant to IRC Section 1411(c)(1)(A)(i). For regular income tax purposes, a portion of an annuity payment is allocated to the taxpayer's investment in the annuity. That amount is excluded from gross income,[5] and, thus, not treated as net investment income. The difference between the total payment and the excluded amount is included in gross income,[6] as well as net investment income.[7]

1. IRC Sec. 1411(c)(5), Treas. Reg. §1.1411-8(a).
2. Treas. Reg. §1.1411-8(b)(2).
3. Treas. Reg. §1.1411-8(b)(3).
4. Treas. Reg. §1.1411-8(b)(2).
5. IRC Section 72(b).
6. IRC Section 72(a).
7. Treas. Reg. §1.1411-4(a)(1)(i). See also Preamble to Proposed Regulations, 77 Fed. Reg. 72618; Preamble to Final Regulations, 78 Fed. Reg. 72394.

> *Example*: In 2014, Amy Annuitant received $12,000 in annuity payments of which $7,000 was allocated to her investment in the annuity. As a result, pursuant to IRC Section 72(b), Amy would exclude $7,000 of the payments from gross income and net investment income. The difference between the total annuity payment of $12,000 and her $7,000 basis, or $5,000 would be included in gross income and in net investment income, subject to the net investment income tax.

If the taxpayer *sells* the annuity contract for a gain, the entire gain would be treated as net investment income either under IRC Section 1411(c)(1)(A)(i) (as annuity income) or 1411(c)(1)(A)(iii) (net gain attributable to the sale of property). For example, if the sales price of the annuity does not exceed the annuity surrender value, the gain recognized (difference between the sales price and the taxpayer's investment or basis in the annuity) is treated as annuity income. If the sales price exceeds the annuity surrender value, the portion of the gain attributable to the difference between the surrender value and the taxpayer's investment or basis in the annuity is also treated as annuity income. However, the gain attributable to the difference between the sales price and the surrender value of the annuity would be treated as net gain attributable to the sale of the annuity.[1]

8584. What is "net gain" with respect to the disposition of property and net investment income?

Pursuant to IRC Section 1411(c)(1)(A)(iii), "net gain" attributable to the disposition of property is included in net investment income. Significantly, the term "net gain" means that dispositions of property that trigger gain that are netted against "losses" generated in those same types of dispositions. Similar to regular income taxation, only taxable gains and non-deductible losses are considered. Thus, because the gain must be "recognized" for income tax purposes, dispositions of property that are income tax-free are also net investment income tax-free. Examples of such tax-free gains include but are not limited to like-kind exchanges under IRC 1031 (See Q 8605 to Q 8626) and involuntary conversions (See Q 8605 to Q 8614).[2]

Although the term "net gain" means that the gains and losses described above have been netted, as discussed in Q 8589, gain attributable to the disposition of property held by a trade or business in which the taxpayer materially participates, i.e., non-passive (other than a trade or business trading in financial instruments and commodities) is excluded from net investment income. In other words,

- Net gain recognized from the disposition of property held in a trade or business in which the taxpayer materially participates – not included in net investment income
- Net gain recognized from the disposition of property held in a trade or business in which the taxpayer does not materially participate – included in net investment income.

1. IRC Section 1411(c)(1)(A)(iii).
2. Treas. Regs. §§1.1411-4(a)(1)(iii), 1.1411(d) (see examples).

- Net gain recognized from the disposition of investment property (no trade or business involved) – always included in net investment income.

- Net gain recognized from the disposition of any property held by business of trading financial instruments or commodities (regardless of the taxpayer's participation in the business) – always included in net investment income.

See Q 8585 for a discussion of how net investment income gains are netted against net investment income losses.

8585. How are gains from the disposition of property netted against losses in determining "net gain" included in net investment income?

As discussed in Q 8584, above, for purposes of IRC Section 1411(c)(1)(A)(iii) "net gain" means that gains are netted against "losses." For example, a disposition of property held by a trade or business in which the taxpayer does not materially participate (passive) that results in a recognized gain would be offset by a similar disposition of property that results in an allowed deductible loss. Examples of losses include those allowed under IRC Section 165, i.e., casualty losses (see Q 8649), theft losses (see Q 8652), and losses realized as a result of worthless securities (see Q 8699) involving property held by a trade or business in which the taxpayer does not materially participate.

Additionally, the same rules for the deductibility of regular income tax losses also apply to the netting of net investment income losses against gains. So, similar to regular income tax, net investment income ordinary losses are netted against net investment income capital gain and net investment ordinary gain.

Also, the final regulations provide for the offset of capital losses and capital gains in arriving at "net gain" included in net investment income in the same way as they offset each other for regular income tax purposes. For regular income tax purposes, capital losses are deductible to the extent of capital gains plus $3,000 of any excess being deductible against other income. The unused excess loss is carried over to subsequent tax years subject to being netted against capital gains generated in such years.[1] Similarly, for net investment income purposes, a taxpayer may use the same netting rules to reduce "net gain" to zero, with $3,000 of any excess reducing other investment income. Any unused excess capital loss is carried over to subsequent years to be netted against capital gain in the same manner.[2]

Planning Point: Significantly, in the aggregate net investment income losses are only deductible to the extent of net investment income gains meaning that net gain cannot be reduced below zero.[3] In other words, there can never be a "net loss." However, as discussed in Q 8586, the final regulations do allow excess investment income losses to be used to reduce other net investment income.[4]

1. IRC Sec. 1211(b).
2. Treas. Reg. §1.1411-4(d)(2).
3. Treas. Reg. §1.1411-4(d)(2).
4. Treas. Reg. §1.1411-4(f)(1).

8586. Can excess net investment income losses be used to reduce other net investment income?

Yes. As discussed in Q 8586, the offsetting of net investment income losses against net investment income gains can never result in a "net loss." However, pursuant to the final regulations, excess losses may be used to reduce other net investment income provided those losses were deducted in the computation of regular income tax. In other words, the loss must be deductible for regular income tax purposes for it to be deducible in this context.[1]

> *Example*: Iris, a single taxpayer has $125,000 of interest and dividends, $60,000 of ordinary losses from a trade or business in which Iris does not materially participate and long-term capital gain from the sale of undeveloped land. For purposes of IRC Section 1411(c)(1)(A)(iii), the net long-term capital gain is net investment income gain because the property was held for investment and there is no trade or business involved. The $60,000 ordinary losses are net investment income losses because the underlying property was held by a trade or business in which Iris did not materially participate. As a result of netting the $60,000 of ordinary losses against the $50,000 of long-term capital gain, there is an excess loss of $10,000. Assuming the excess loss is deducted for regular income tax purposes, the final regulations allow that amount to be deducted against the Iris' other net investment income, i.e., $125,000 of interest and dividend net investment income (includible under IRC Section 1411(c)(1)(A)(i)).[2]

So in the end, the entire amount of $60,000 of net investment income loss was fully deductible against some type of net investment income. First, $50,000 of the loss offset $50,000 of long-term capital gain. Second, the excess loss, $10,000 was deductible against the $125,000 of interest and dividends, resulting in $115,000 of net investment income.

8587. How does gain on the sale of a taxpayer's principal residence impact the determination of whether the taxpayer is subject to the investment income tax? Also, is any or all of the gain subject to net investment income tax?

The sale of a taxpayer's principal residence is potentially includible in net investment income as net gain from the sale of property.[3] However, for income tax purposes, a single taxpayer excludes the first $250,000 of capital gain realized from the sale of a principal residence from gross income ($500,000 for a married couple filing jointly).[4] Since only amounts included in gross income for regular income tax purposes are included in net investment income, the same amount of gain excluded from gross income is similarly excluded from net investment income.[5] Consequently, the portion of the gain from the sale of a principal residence that is included in gross income is also included in net investment income.[6]

> *Example*: In 2000, Dave and Janice purchased a principal residence for $100,000. In 2014, they sell their residence for $700,000 realizing a total gain of $600,000. Pursuant to IRC Section 121, $500,000 of

1. Treas. Reg. §1.1411-4(f)(1).
2. Treas. Reg. §1.1411-4(h).
3. IRC Sec. 1411(c)(1)(A)(iii). It is treated as investment income because it is not property held in a trade or business in which the taxpayer materially participates.
4. IRC Sec. 121(a).
5. Treas. Reg. §1.1411-1(d)(4)(i).
6. IRC Section 1411(c)(1)(A)(iii).

the gain is excluded from gross income and from net investment income. However, $100,000 of the gain (the amount exceeding the $500,000 exclusion) is includible in gross income and in net investment income. In addition, Dave and Janice have dividend and interest income of $200,000. Their AGI is $425,000.

Applying the formula (see Q 8577), the 3.8 percent net investment tax is imposed on the lesser of:

1. Net investment income of $200,000 (interest and dividends) plus $100,000 (taxable gain on sale of principal residence), a total of $300,000; or

2. The excess of (i) AGI of $425,000 over (ii) the applicable threshold amount of $250,000 (married couple filing jointly), or $175,000.

As illustrated in this example, the taxpayers' net investment income includes the interest and dividend income of $200,000 plus only $100,000 of the $600,000 gain from the sale of their principal residence. The excluded gain of $500,000 pursuant to IRC Section 121 does not factor into the computation. In other words, the amount of gain included in gross income is also the amount of gain treated as net investment income. Thus, because the excess of AGI over the applicable threshold amount ($175.000) is less than the taxpayers' net investment income ($300,000), the 3.8 percent tax is imposed on the lesser amount.

8588. How does a taxpayer determine whether income is derived from the taxpayer's trade or business and, if so, excluded from net investment income?

The test for determining whether interest, dividends, annuities, royalties and rents otherwise included as net investment income pursuant to IRC Section 1411(c)(1)(A)(i) are excluded from net investment income is different from the test to determine whether net investment income otherwise included pursuant to IRC Sections 1411(c)(1)(A)(ii) and (iii) are similarly excluded.

As to IRC Section 1411(c)(1)(A)(i) net investment income, i.e., the traditional types of investment income, the exclusion applies if such income is derived in the "ordinary course" of a trade or business within the meaning of Treasury Regulation Section 1.469–2T(c)(3)(ii). This means the income is the type the trade or business is designed to generate. The following are examples of such income:

1. Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

2. Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

3. Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

4. Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business;

5. Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.[1]

The common denominator in these examples is the nexus between the trade or business and the income generated. For example, interest income on loans is the type of income a bank is designed to generate. Conversely, interest or dividend income derived from invested working capital for future use in the taxpayer's trade or business is not that type of income; and, thus is treated as net investment income.[2] Moreover, under no circumstances is any income derived from trading in financial instruments or commodities ever be excluded from net investment income.[3]

As to income derived in a trade or business that is not treated as net investment income pursuant to IRC Sections 1411(c)(1)(A)(ii) and (iii), there is a much looser test for the application of the exclusion. That test is the same for both sections. As discussed in Q 8579, IRC Section 1411(c)(1)(A)(ii) deals with the regular gross income of a trade or business. Conversely, IRC Section 1411(c)(1)(A)(iii) deals with net gain attributable to the sale or exchange of property.

Unlike the IRC Section 1411(c)(1)(A)(i) exclusion, there is no requirement that the income must be of the type that the trade or business is designed to generate. Instead, to qualify for the exception, the income must be derived from a trade or business in which the taxpayer materially participates (non-passive) and under no circumstances is the income derived from trading in financial instruments or commodities.[4] Stated differently, pursuant to IRC Section 1411(c)(1)(A)(ii), net investment income includes all income derived from a trade or business that is passive with respect to the taxpayer. However, if the trade or business is non-passive with respect to the taxpayer, the income is excluded from net investment income. For a discussion regarding determining whether an activity is passive or non-passive, see Q 8589.

> As mentioned above, the same test is used to determine whether net gain attributable to disposition of property (sale or exchange) otherwise included in net investment income pursuant to IRC Section 1411(c)(1)(A)(iii) is excluded from net investment income. In applying this test, the net gain is excluded only if the disposed of property is held in a trade or business which is non-passive with respect to the taxpayer and is not derived from a business trading in financial instruments or commodities. Thus, the net gain from the disposition of property held by a trade or business that is passive with respect to the taxpayer would be included in net investment income.

1. Treas. Regs. §1.469-2T(c)(3)(ii); 1.1411-6.
2. IRC Section 1411(c)(3).
3. IRC Sec. 1411(c)(2).
4. IRC Sec. 1411(c)(2).

Net Investment Income Exclusion for Income Derived in the Taxpayer's Trade or Business

	Included as Net Investment Income	**Excluded from Net Investment Income**
IRC Section 1411(c)(1)(A)(i) Interest, Dividends, Annuities, Rents and Royalties	Traditional Investment Income	The type of income the business was designed to generate, i.e., interest income earned by a bank.
IRC Section 1411(c)(1)(A)(ii) Gross Income from a Trade or Business	Income derived from a trade or business that is passive with respect to the taxpayer or derived from a business trading in financial instruments or commodities. Also includes income from an activity that does not arise to the level of a trade or business.	Income derived from a trade or business that is non-passive with respect to the taxpayer other than income derived from a business trading in financial instruments or commodities.
IRC Section 1411(c)(1)(A)(iii) Net Gain from the Disposition of Property Held in a Trade or Business	The underlying trade or business is passive with respect to the taxpayer or is a business trading in financial instruments or commodities.	The underlying trade or business is non-passive with respect to the taxpayer and is not a business trading in financial instruments or commodities.

8589. What is the importance of whether trade or business activities are considered "passive" with respect to the taxpayer?

Prior to the enactment of the net investment income tax, the relevance of "passive" activities was to limit deductible passive expenses to passive income.[1] Now, as a result of the net investment income tax, the characterization of an activity as passive has new significance. As discussed in Q 8588, gross income derived from a trade or business and/or net gain attributable to the sale or exchange of property that is passive with respect to the taxpayer is included in net investment income subject to the 3.8 percent net investment income tax. To qualify for the exclusion, the taxpayer must "materially participate" in the business activity so as to make it a non-passive activity.

Section 1411 and the regulations reference the definition of passive activity set forth in IRC Section 469, indicating that the rules for determining whether an activity is active or passive apply in the context of determining whether the income is included in investment income.[2] Whether an activity is passive or non-passive depends on the level of the taxpayer's participation

1. IRC Sec. 469.
2. IRC Sec. 1411(c), Treas Reg. §1.1411-5(b).

in the activity. A passive activity is any trade or business activity in which the taxpayer does not "materially participate."[1] Generally, a taxpayer is considered to *materially participate* in an activity if he is involved in the operations of the activity on a regular, continuous, and substantial basis. Many of the factors considered by the IRS involve the number of hours that the taxpayer devotes to the activity annually. The IRS may also compare the number of hours that a taxpayer devotes to the activity to the hours spent by others engaged in the same business. A traditional facts and circumstances test is typically applied in making a final determination. See Q 8638 for a discussion of the material participation requirement in the context of the passive activity rules.

So, if a taxpayer materially participates in a trade or business, it is considered non-passive; and, thus, the income described above would qualify for the exclusion. As an important caveat, even if the taxpayer participates in a trade or business, if the income from such business is considered to be self-employment income, it can never be considered net investment income. Instead, such income is subject to Medicare tax and potentially the Additional Medicare tax.[2]

For a detailed discussion of the passive activity rules in general, see Q 8635 to Q 8644.

8590. Can a taxpayer "group" multiple activities in order to meet the material participation test for purposes of the net income investment exclusion?

Another way to meet the material participation test is to "group" several activities into a single activity to meet the material participation test. Under Treasury Regulation Section 1.469-4,[3] one or more trade or business activities may be "grouped" and treated as one economic unit for purposes of determining whether the taxpayer materially participated. By doing so, the taxpayer's participation for all the activities would be aggregated as if it was one activity. Whether or not the IRS will recognize grouped activities as a single economic unit is based on facts and circumstances. The following five factors are relevant in determining whether such activities qualify to be treated as a single economic unit:[4]

(1) similarities and differences in types of trades or businesses,

(2) the extent of common control,

(3) the extent of common ownership,

(4) geographical location and

(5) interdependencies between or among the activities.

Once a taxpayer has grouped activities, the taxpayer is generally not permitted to regroup those activities in later tax years.[5] See Q 8591 for the limited exception to this rule.

1. IRC Sec. 469(c).
2. IRC Section 1411(c)(6).
3. Treas. Reg. §1.469-4.
4. Treas. Regs. §§1.469-4(c)(1), 1.469-4(c)(2).
5. Treas. Reg. §1.469-4(e)(1).

8591. Can a taxpayer regroup activities after an initial grouping has already taken place?

Obviously, the grouping rules were the outgrowth of the passive activity income and loss rules that far predate the enactment of the net investment income tax. For the reason, allowing the taxpayer to regroup certain activities in view of net investment income tax considerations could potentially save a significant amount of tax.

The final regulations provide a small window allowing such a regrouping. In order to regroup,

(1) the regrouping must occur only in the first taxable year beginning after December 31, 2012; and

(2) the regrouping taxpayer must be subject to net investment income during that year.

In other words, regrouping is allowed only in the one single tax year referenced above, and, only if a taxpayer is subject to net investment income in that same year. Consequently, any taxpayer who is not subject to net investment income in that taxable year, but may be subject to it in a subsequent year, is not entitled to a "fresh start" regrouping.[1]

Planning Point: In drafting the final regulations, the IRS refused to allow pass through entities such as S corporations and partnerships to regroup. In declining to do so, the final regulations noted that taxpayers not subject to the net investment income tax for the taxable year beginning after December 31, 2012, would get the benefit of regrouping indirectly (i.e., by virtue of the pass through of income from those entities), that they would not be entitled to receive directly.[2]

For additional discussion of the passive activity rules in general, see Q 8635 to Q 8644.

8592. How does the investment income tax effectively increase the tax rate for capital gains and dividends?

The 3.8 percent net investment income tax is a surtax, which means it is imposed independently on net investment income that is also subject to any other applicable income tax rate. To this point, the capital gains and dividend tax rate for taxpayers in the 39.6 percent tax bracket is 20 percent. However, if the taxpayer is also subject to the net investment income tax, there is an additional 3.8 percent tax imposed on those same capital gains and dividends. Thus, adding the two tax rates together, the overall effective tax rate for capital gain and dividends for those taxpayers is 23.8 percent (20% plus 3.8%).

For taxpayers who are not in the 39.6 percent tax bracket, the capital gains and dividend tax rate is only 15 percent. However, it is possible that such taxpayers with modified adjusted gross income that exceeds the threshold levels for the net investment income tax (see Q 8580) may also be subject to the net investment income tax. Adding the 15 percent regular income tax

1. Preamble to Final Regulations, 78 Fed. Reg. 72396.
2. Preamble to Final Regulations, 78 Fed. Reg. 72396.

capital gain and dividend rate to the 3.8 percent net investment income tax rate, the effective rate of such taxpayers would be 18.8 percent (15% plus 3.8%).

8593. Can federal income tax credits be used to offset net investment income tax liability?

Although Federal income tax credits set forth in Subtitle A of the IRC can offset any tax liability, the final regulations state that income tax credits are allowed only against regular income tax (Chapter 1 of Subtitle A) and may not reduce net investment income tax.[1] Examples of this type of tax credit include the foreign income tax credit and the general business tax credit.[2]

The denial of tax credits as an offset of the net investment income tax is reflected by the sequence of reporting tax and tax credits on Form 1040. To this point, regular income tax is reported on line 46 of Form 1040. All tax credits reducing that regular income tax are taken on the following lines 47 – 53. Beginning on line 56, the "other taxes" including the net investment income tax (reported on line 60) are reported. So logistically, all tax credits that reduce regular income tax are taken *before* the entry for the net investment income tax. Moreover, none of those credits are refundable credits (meaning the credits can only reduce the regular tax to zero and not generate a refundable overpayment). Thus, they are of no consequence with regard to the net investment income tax reported on line 60.

8594. What form is used to report net investment income tax?

As mentioned above, net investment income tax is reported on line 60 of Form 1040. On Form 8960 (attached to Form 1040), the taxpayer computes the tax. In addition to reporting all the taxpayer's net investment income, amounts reported on Form 8814 (Parents' Election to Report Child's Interest and Dividends) are also included.

Planning Point: Similar to regular income tax or self-employment tax, individuals who expect to be liable for the net investment income tax may either make estimated tax payments or request their employer to withhold additional amounts to avoid being subject to penalties for underpayment of taxes.[3]

8595. When is an estate or trust subject to the investment tax?

Certain trusts and estates are also subject to the 3.8 percent net investment income tax. Basically, the tax is imposed on any net investment income that remains in the estate or the trust and, thus, is not distributed to beneficiaries, otherwise referred to as "undistributed net investment income." Unlike individual taxpayers, the threshold amount is the amount at which the highest regular income tax bracket begins. Additionally, unlike the applicable threshold amount for individuals, the applicable threshold is adjusted for inflation.[4] For example, in 2014, the amount at which the highest income tax bracket begins is adjusted gross income in excess of $12,150. Since this amount is relatively low, many estates and trusts are likely to be subject to the tax.

1. Treas. Reg. §1.1411-1(e).
2. See IRC Secs. 27, 901, 38.
3. IRS Q&A on the Net Investment Income Tax, available at: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs (last accessed April 25, 2014).
4. IRC Sec. 1411(a)(2)(B)(ii).

The following examples are used to demonstrate the computation of the net investment income tax for a trust.

> *Example*: In 2014, the Dinosaur trust has AGI of $16,000 and undistributed net investment income of $6,000.
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> The net investment income tax is imposed on trusts and estates on the lesser of:
>
> 1) Undistributed Net Investment Income, $6,000: or
>
> 2) The excess of (i) AGI of $16,000, over (ii) $12,500, the amount at which the highest regular tax bracket begins, or $3,850.

Even though there is $6,000 of undistributed net investment income, because the lesser of the two amounts is $3,850, only that amount is subject to the 3.8 percent net investment income tax.

> *Example*: In 2015, the Dinosaur trust has AGI of $20,000 and undistributed net investment income of $6,000.
>
> The net investment income tax is imposed on trusts and estates on the lesser of:
>
> 1) Undistributed Net Investment Income, $6,000: or
>
> 2) The excess of (i) AGI of $20,000, over (ii) $12,500, the amount at which the highest regular tax bracket begins, or $7,850.

Because the lesser of the two amounts is the undistributed net investment income of $6,000, the entire amount of undistributed net investment income is subject to the 3.8 percent net investment income tax.

8596. Which trusts are not subject to the net investment income tax?

Trusts not subject to the net investment income tax include charitable trusts exempt from tax under IRC Section 501[1] or IRC Section 664[2] (charitable remainder trusts) and trusts that are not classified as "trusts" for federal income tax purposes.[3] Moreover, if all of the remaining interests in a trust are designated for certain qualified purposes, the trust is not subject to the net investment income tax. These qualified purposes described in IRC Section 170(c)(2)(B) include religious, charitable, scientific, literary or educational purposes.[4]

Finally, grantor trusts such as revocable trusts are not subject to the net investment income tax. This is because the income of a grantor trust is taxed directly to the grantor. As a result, any net investment income generated by the trust is included in the grantor's net investment income – potentially subject to the 3.8 percent tax.[5]

1. Treas. Reg. §1.1411-3(b)(1)(ii).
2. Treas. Reg. §1.1411-3(b)(1)(iii).
3. Treas. Reg. §1.1411-3(b)(1)(iv).
4. Treas. Reg. §1.1411-3(b)(1), IRC Sec. 170(c)(2)(B).
5. Treas. Reg. §1.1411-3(b)(1)(v).

8597. What considerations are relevant in determining if a trade or business is non-passive with respect to a trust for purposes of treating the income derived therefrom as excluded from net investment income?

As discussed in Q 8589, whether a trade or business activity from which the taxpayer derives income from is passive depends on the taxpayer's level of participation in the activity in question. In the case of a trust that owns interests in a pass-through entity, such as an S corporation or partnership, it is the trustee's participation in the business activities that is relevant in determining whether the investment is active or passive with respect to the trust.

In a 2013 technical advice memorandum, the IRS expressed a restrictive view of what participation in a business activity by a trustee is attributable to the trust. In that memorandum, the IRS declared that a trustee's participation in a business in which the trust owned interests was *not* material even though the trustee was also the president of the company through which the business activity was conducted.[1] The IRS reached this conclusion based on its view that the trustee's participation in the company as an *employee* was separate from his role as trustee; and, thus, it was not attributable to the trust. Further, although the IRS did count the trustee's time spent serving as *trustee* in dealing with the company's business, it determined that the trustee's activities were nonetheless not "regular, continuous and substantial" within the meaning of IRC Section 469 (governing passive activities generally).[2]

Although the technical advice memorandum did not address the issue of whether the trust income was net investment income, it reflects the IRS view that the participation of a trustee as an employee or officer of an entity is not attributed to his or her role as the trustee. Based on such a restrictive view of the role of the trustee, it may be virtually impossible for any trust to materially participate in a business activity.

However, in a recent decision, the Tax Court rejected the IRS' restrictive position.[3] In that case, a trust owned rental real estate properties and engaged in other real estate activities. Three of the five trustees worked full-time in the trust's wholly owned rental real estate LLC. The issue was whether the personal services of the trustees as employees of the LLC would be attributable to the trust.

Pursuant to IRC Section 469(c)(2), all rental activities are passive. In order to rebut that characterization, IRC Section 469(c)(7)(B) requires the taxpayer to meet the following two tests: (1) more than one-half of the personal services performed in the trades or businesses by the taxpayer during the taxable year is performed in real property trades or businesses in which the taxpayer materially participates; and, (2) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

Consistent with the technical advice memorandum, the IRS argued that the personal services performed by the trustees as employees of the LLC were not attributable to the trust.

1. TAM 201317010.
2. IRC Sec. 469(h)(1).
3. *Frank Aragona Trust et. al. v. Comm.*, 142 T.C. No. 9 (March 27, 2014).

The Tax Court, however, rejected the IRS' view as being too narrow and held that the participation of the trustees as employees were attributable to the trust. So, because the activities of those trustees/employees met the two IRC Section 469(b)(7)(B) tests, the trust was deemed to have materially participated in the rental real estate activities, and, for that reason, they were non-passive activities.

Planning Point: Although the Tax Court case also did not involve net investment income, based on the holding, the non-passive rental income would have most likely been excluded from net investment income. Additionally, the Tax Court case is significant because it was a regular opinion reviewed by the entire Tax Court bench rather than a Tax Court Memorandum decision that carries less authoritative weight. In any event, IRS has not yet indicated whether it will follow the decision or continue to apply the restrictive view of the technical advice memorandum. Because a low applicable threshold subjects many trusts to the net investment income tax (see Q 8595), trustees should pay attention to how the IRS will deal with this issue as it relates to treating rental real estate activities of a trust as passive or non-passive.

8598. What is the additional Medicare tax? Who is liable for paying the additional Medicare tax?

The additional Medicare tax is a tax of 0.9 percent that is tacked on to the "regular" Medicare tax on all wages and self-employment income (collectively referred to as "earned income") that exceed applicable thresholds amounts. Thus, on earned income in excess of the applicable threshold amount, the total Medicare tax rate is 3.8 percent (the 2.9 percent regular Medicare tax rate plus the 0.9 percent additional Medicare tax rate).

In spite of its name, the tax revenue generated by the Additional Medicare tax is not specifically earmarked for the Medicare fund. Similar to the regular Medicare tax, the additional Medicare tax is imposed only on individual taxpayers (see Q 8599 for a discussion of an employer's obligation to withhold the additional Medicare tax). Thus, entities such as C corporations, trusts and estates are not subject to the tax.[1]

The applicable thresholds for the additional Medicare tax (not adjusted for inflation) are the sum of the taxpayers earned income (wages and/or self-employment income) in excess of the following amounts:

(1) $250,000 for married taxpayers filing jointly;

(2) $125,000 for married taxpayers filing separate returns; and

(3) $200,000 for single taxpayers and heads of households.[2]

Planning Point: The tax base of the additional Medicare tax and the net investment income are mutually exclusive. To this point, the additional Medicare surtax is imposed on earned income whereas the net investment income tax is imposed on investment income. This means that a taxpayer cannot be subject to both additional taxes on the same income.[3] If income could be included in both tax bases, it will be included in the Medicare tax base.

1. IRC Sec. 3101(b)(2).
2. IRC Sec. 3101(b)(2).
3. IRS FAQ, Questions and Answers for the Additional Medicare Tax, available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax (last accessed April 23, 2014).

8599. If one spouse's wages exceeds $200,000, triggering mandatory withholding by the employer of the additional Medicare tax, but when combined with the second spouse's wages, the couple's wages are less than the $250,000 threshold for married taxpayers filing jointly (meaning there is no additional Medicare tax owing), can the first spouse request his or her employer not to withhold the additional Medicare tax?

No. Pursuant to IRC Section 3102(a), once an employee's wages exceed $200,000 (the mandatory wage withholding amount), the employer must withhold 0.9 percent of the excess amount even if the employee does not actually owe any additional Medicare tax. So for wages in excess of $200,000, the employer must withhold the additional Medicare tax even if those wages combined with his or her spouse's wages do *not* exceed the applicable threshold for a married couple filing jointly ($250,000).[1] To the extent the amount withheld exceeds the employee's liability, the employee's remedy is to apply it as a payment against other tax he or she may owe or receive a refund for the excessive withholding.

8600. What are the consequences of an employer's failure to withhold the additional Medicare tax that an employee is liable to pay?

There are several possible ways that an employer might fail to withhold the additional Medicare tax an employee is liable to pay. For example, it might occur if both spouses individually earn wages under the mandatory $200,000 withholding amount. So, if one spouse has wages of $100,000 and the other spouse has wages of $199,000, neither spouse's wages are subject to mandatory withholding. Yet, because the couple's combined wages of $299,000 exceed the $250,000 applicable threshold by $49,000, they must pay the additional Medicare tax on that amount. Thus, on Form 8959, the couple would compute the additional Medicare tax of 0.9 percent on $49,000 – reporting it on line 60 of Form 1040.[2]

On the other hand, an employer obligated to withhold the additional Medicare tax on wages in excess of $200,000 may simply fail to do so. Under those circumstances, the employer remains obligated to pay the tax to the IRS unless and until the employer can prove that it was paid by the employee. However, even if the employee ultimately pays the tax, it does not relieve the employer of its liability for any interest or penalties assessed as a result of its failure to withhold the additional Medicare tax.[3]

8601. Can a taxpayer request additional withholding specifically earmarked to pay anticipated additional Medicare tax?

No, a taxpayer cannot make such a request. However, the taxpayer may modify Form W-4 to request his or her employer to withhold additional income tax. Even though the additional

1. IRS FAQ, Questions and Answers for the Additional Medicare Tax, available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax (last accessed April 14, 2014); Treas. Reg. §31.3102-4(a).
2. Treas. Reg. §31.3102-4(b), Example J.
3. Treas. Reg. §31.3102.4(c).

amount withheld is technically regular income tax (not additional Medicare tax), it is nonetheless credited as a payment to be applied to all Form 1040 tax liability owing including the additional Medicare tax.[1]

8602. Can a taxpayer make estimated tax payments to cover the additional Medicare tax liability?

Although the additional Medicare tax is a separate tax, the IRS considers it to be part of the taxpayer's overall tax liability. So, if the taxpayer's withholdings are not sufficient to cover the entire tax liability, there may be a penalty imposed on the failure to make an estimated tax payment. For that reason, it may behoove a taxpayer who does not increase the amount withheld by the employer to make estimated payments to cover any shortfall.[2]

8603. How does a taxpayer calculate additional Medicare tax liability if the taxpayer receives both wage income and self-employment income in the same tax year?

The taxpayer's combined wages and/or self-employment income is subject to the additional Medicare tax. This means the tax is imposed on the excess of the taxpayer's entire amount of earned income over the applicable threshold. The following fact pattern demonstrates the three-step procedure for calculating the tax owed:

> *Example*: Sam is a single taxpayer with $130,000 in wages and $145,000 in self-employment income, or total earned income of $275,000. The applicable threshold for a single taxpayer is $200,000.
>
> Step 1 - Calculate additional Medicare tax on wages in excess of the applicable threshold;
>
> As mentioned above, the applicable threshold for a single taxpayer is $200,000. However, since Sam's wages of $130,000 do not exceed the applicable threshold, there is no additional Medicare tax on his wages.
>
> Step 2 - Reduce the applicable threshold by the total amount of wages, but not below zero;
>
> In this case, the applicable threshold of $200,000 minus Sam's $130,000 of wages equals a reduced threshold of $70,000.
>
> Step 3 - Calculate the additional Medicare tax on any self-employment income received in excess of the reduced threshold.

In Step 1, $130,000 of the applicable threshold is absorbed by Sam's wages. Then, in Step 2, the applicable threshold minus Sam's wages is reduced to $70,000. Finally, in Step 3, Sam's self-employment income of $145,000 exceeds the reduced threshold of $70,000 by $75,000, the amount of Sam's self-employment income subject to the additional Medicare tax. The actual tax is $675 (0.9% * $75,000).

1. See IRS Q&A on the Additional Medicare Tax, available at: http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax (last accessed April 25, 2014).
2. See IRS Q&A on the Additional Medicare Tax, available at: http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax (last accessed April 25, 2014).

8604. Are noncash fringe benefits received by an employee subject to the additional Medicare tax?

Yes. The value of any taxable noncash employee fringe benefits is added to his or her cash wages to determine whether the taxpayer's overall wage income exceeds the applicable threshold (see Q 8598). If so, the excess amount will be subject to the additional Medicare tax.[1] Moreover, similar to the payment of only cash wages, if the combined amount of cash wages and taxable noncash fringe benefits exceeds the mandatory wage withholding amount of $200,000 (see Q 8599), the employer must withhold the additional Medicare tax on the excess amount of combined wage income.[2]

See Q 8778 to Q 8804 for a discussion of the tax treatment of various noncash fringe benefits.

1. IRS FAQ, *Questions and Answers for the Additional Medicare Tax*, available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax (last accessed April 23, 2014).
2. IRS FAQ, *Questions and Answers for the Additional Medicare Tax*, available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax (last accessed April 23, 2014).