CARLTON FIELDS

Planning for the Affordable Care Act's Net Investment Income Tax

May 02, 2013

The new Internal Revenue Code ("IRC") Section 1411, which imposes a 3.8 percent tax on net investment income ("NII") was passed as part of the Affordable Care Act of 2010 ("ACA") and is effective for tax years beginning on or after January 1, 2013. The proposed regulations become final December 31, 2013. Until then, taxpayers may rely on the proposed regulations to comply with IRC section 1411. This alert discusses the types of income that NII includes and excludes, as well as which individuals, estates, and trusts will be subject to the new tax. The NII tax makes newly relevant the "material participation" standard, which was historically important in the S corporation and partnership contexts to determine whether losses pass through to an entity's owners. NII includes trade or business income derived from a passive activity (within the meaning of IRC section 469) and from trading in financial instruments or commodities. Under IRC section 469, if a taxpayer materially participates in a trade or business, then income generated by that trade or business is not passive activity income. Taxpayers who materially participate in a trade or business, then, may not be subject to the 3.8 percent NII tax. Additionally, the NII tax does not apply to nonresident alien individuals, or to trusts that are tax exempt for charitable purposes. However, the NII tax may apply to certain foreign trusts. The U.S. Department of the Treasury ("Treasury") recently proposed regulations that clarify the definition of NII. NII includes interest, dividends, capital gains, rental and royalty income, nonqualified annuities, income from businesses involved in trading financial instruments or commodities, and businesses that are passive activities. NII does not include wages, unemployment compensation, operating income from nonpassive businesses, Social Security benefits, alimony, tax exempt interest, self-employment income, Alaska Permanent Fund dividends, and distributions from certain qualified plans. NII also does not include any gain that is excluded from gross income for regular income tax purposes, such as the first $250,000 ($500,000 for married couples) of gain from the sale of a principal residence. However, Treasury did not exempt income earned by all foreign trusts from the NII definition. In fact, the preamble to the proposed regulations states that the IRS and Treasury believe that the NII of "a foreign estate or foreign trust should be subject to section 1411 to the extent such income is earned or accumulated for the benefit of, or distributed to, United States persons." The NII tax applies to individuals, estates, and trusts that earn NII and have modified adjusted gross income in excess of certain thresholds. For individuals, the threshold is $200,000 for single filers and $250,000 for individuals who are married and file jointly.

For trusts and estates, the threshold amount for 2013 is $11,950. Unlike the threshold for trusts and estates, the threshold for individuals is not adjusted for inflation. If an individual, estate, or trust earns NII and exceeds the thresholds, then that individual, estate, or trust is subject to an additional 3.8 percent tax on NII. NII is not subject to the additional 0.9 percent Medicare Tax that is also part of the ACA. If you have questions regarding this alert or the other tax rate increases effective January 1, 2013, please contact our tax attorneys.

Related Practices

Tax
Business Transactions
Estates, Trusts and Probate