
The 3.8% Medicare Tax on Investment Income

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- Enacted as part of the Health Care and Education Reconciliation Act of 2010
- Beginning in 2013
 - 3.8% tax on certain “net investment income”
 - This new tax will apply to individuals, estates and trusts.
- IRS guidance is coming soon, we hope.
- The statute aims to tax “net investment income” -- but not all of it. We’ll go over:
 - I. What is included in “net investment income” (NII)
 - II. How much NII gets surtaxed?
 - III. Planning ideas - Individuals
 - IV. Planning ideas - Trusts and Estates

I. What's "Net Investment Income" (NII)?

“Net Investment Income”

- First a warning: The term “Net Investment Income” is already used in other areas of the tax law. So beware of confusing these.
- Other use #1: “Investment Interest” is deductible to the extent of “net investment income”
 - In that statute, “net investment income” is defined differently
- Other use #2: A tax-exempt private foundation is subject to a 2% tax on its “net investment income”
 - Also defined differently

“Net Investment Income” is defined
as 3 categories of income

Category #1: Gross income from interest, dividends, annuities, royalties and rents;

- This would exclude tax-exempt municipal bond income
- Interest, dividends, etc, from a partnership or S corporation would be interest or dividends to the partner/shareholder for purposes of this 3.8% tax.

“Net Investment Income” is defined
as 3 categories of income

Category #2: Gross income from (1) a passive activity, or (2) a trade or business of trading in financial instruments or commodities;

- “Passive activity” is a business in which you do not “materially” participate.
- Includes business income from Master Limited Partnerships (MLPs) that operate as LLCs. That income flows through to passive investors as passive business income.
- Includes business income from closely-held family businesses in LLC or S corporation form, where some family members own units/shares but are not involved in the business (i.e., they are “passive” under the tax rules).
- Rental income from a passive activity would be included in “net investment income.” Rental income from an active trade/business would be excluded.

“Net Investment Income” is defined as 3 categories of income

Category #3: Net gain “to the extent taken into account in computing taxable income.”

- This would be capital gain, net of capital losses.
 - **Possible issue.** The statute subjects to tax net investment income “for such taxable year.” It’s unclear whether this might also limit capital losses (for this tax) to those incurred in the current taxable year (i.e., carryforward capital losses can’t be used)
 - Similar issue for Passive Activity Losses
- Gain excluded from income for regular tax purposes is also be excluded from NII. This would exclude:
 - gain on the sale of a principal residence that is excluded from income under Section 121 (up to \$250,000; \$500,000 for a married couple);
 - gain on the sale of Qualified Small Business Stock that is excluded from income;
 - gain on tax-free like-kind exchanges;
 - gain on the sale of stock to an ESOP that is excluded from income due to the purchase of “qualified replacement property”;
 - gain on the tax-free exchange of insurance policies;
 - the internal “build up” of value inside a life insurance policy.

Net Investment Income” is defined as 3 categories of income

Category #3 continued: Net gain “to the extent taken into account in computing taxable income.”

- “Net gain” is defined to be net gain “attributable to the disposition of property other than property held in a [non-passive] trade or business.”
 - In other words, gain on the sale of assets of a business would not be subject to the 3.8% surtax.
- It would seem the term “net gain” could also be broad enough to include “recapture” income that is often recognized on the sale of investment real estate.

Special Rule for Partnerships and S corps

Disposition of S corporation stock or partnership interests.

Only part of the gain is surtaxed

- The seller's share of the gain that would be subject to the 3.8% surtax as Category 3 "net gain" if the entity (the S corporation or partnership) had sold all of its property for fair market value "immediately before" the stock or partnership interest was sold.

This is intended to be a pro-taxpayer provision, shielding from the 3.8% surtax net gain attributable to an active trade or business in which the taxpayer is a material participant.

Example.

- You are a 50% partner and a material participant in an active business.
- You sell your 50% partnership interest for a gain, which would be subject to the 3.8% surtax.
- Assume that if the partnership sold all of its assets, because you are active in the business, that would be the sale of business assets that, as mentioned above, is not subject to the 3.8% surtax, and your share of that would be 50%.
- Because none of your share of the gain from a hypothetical sale would be subject to the 3.8% surtax, none of your gain on the sale of your partnership interest would be subject to the 3.8% surtax.

Summary of Treatment of Gain on Sale of Business

Assume this is a non-passive business owner: would gain on the sale be “Net Investment Income” for purposes of the 3.8% surtax?		
	Asset Sale	Stock Sale
Business in S corp form	No. The tax NA to gain from sale of an asset use in trade or business.	No. Special rules allows the business aspect to flow through, making it gain on the sale of business asset.
Business in LLC/Partnership form	No. Same as above	No. Same as above
Business in C corporation form	No. The tax N/A to C corps	Yes, this would be “net gain” includible in NII, unless the gain is not recognized (e.g., QSB stock exclusion/rollover, ESOP rollover, etc.)

“Net investment income” does not include distributions from the following qualified retirement plans:

- qualified pension, profit-sharing, and stock bonus plans;
- qualified annuity plans;
- annuities for employees of tax-exempt organizations or public schools;
- IRAs;
- Roth IRAs;
- deferred compensation plans of state and local governments organizations.

Possible issue. These distributions would not seem to fit within any of the 3 categories anyway. So why make a special rule to except them? By singling out such qualified retirement plan distributions, is the negative implication that distributions from nonqualified plans (e.g., Restoration Plan payouts) are indeed subject to the tax?

What is not “Net Investment Income”?

Everything else. Examples are:

- compensation income
- salary
- income on the exercise of compensatory options
- vesting of restricted stock
- qualified retirement plan distributions are also excepted from the definition of net investment income, as mentioned above.

NOTE: These are still in MAGI, which can indirectly trigger the 3.8% surtax, as we’ll see.

II. How much of NII is subject to the 3.8% surtax

How much NII is taxed -- the Thresholds

For an individual, the 3.8% tax is imposed on the lesser of (i) “Net Investment Income”, or (ii) the excess of “modified adjusted gross income”* over a certain threshold amount.

Filing Status	Threshold
Married filing jointly, or Qualifying Widow[er]	\$250,000
Single, Head of Household	\$200,000
Married filing separately	\$125,000
Trusts/Estates	\$12,000*

* *Technically not called a "threshold." Operates same way.*

For trusts and estates, the 3.8% tax is imposed on the lesser of (i) undistributed NII, or (ii) the excess of adjusted gross income over the dollar amount at which the highest tax bracket is reached for estates and trusts. That amount is \$11,650 in 2012. That amount is indexed for inflation and will be app. \$12,000 in 2013.

* “Modified adjusted gross income” is another term that is also used in other tax statutes but with a different meaning. For purposes of the 3.8% tax, it means adjusted gross income increased by the net amount of foreign-sourced income that was exempt for regular tax purposes.

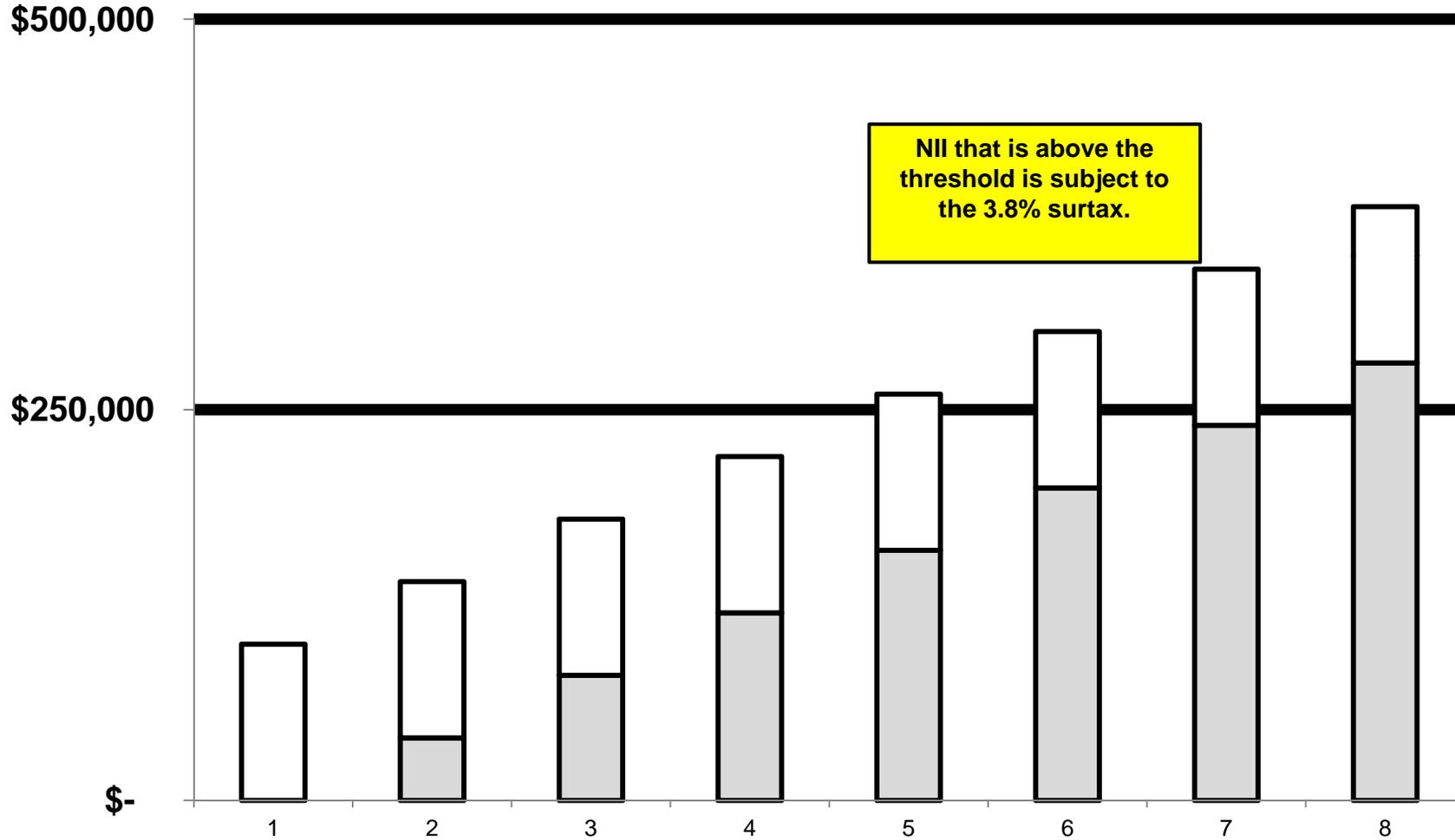
How much NII is taxed; how do the thresholds work – a pictorial explanation

The next slide assumes:

- Your threshold is \$250,000 (e.g., married filing jointly);
- Your level of NII (the white rectangle) is fixed at \$100,000;
- Your Other Income (the shaded rectangle) will vary

“Net Investment Income” Fixed Other Income Varies

□ Other Income □ NII = \$100,000



Takeaways from previous slide

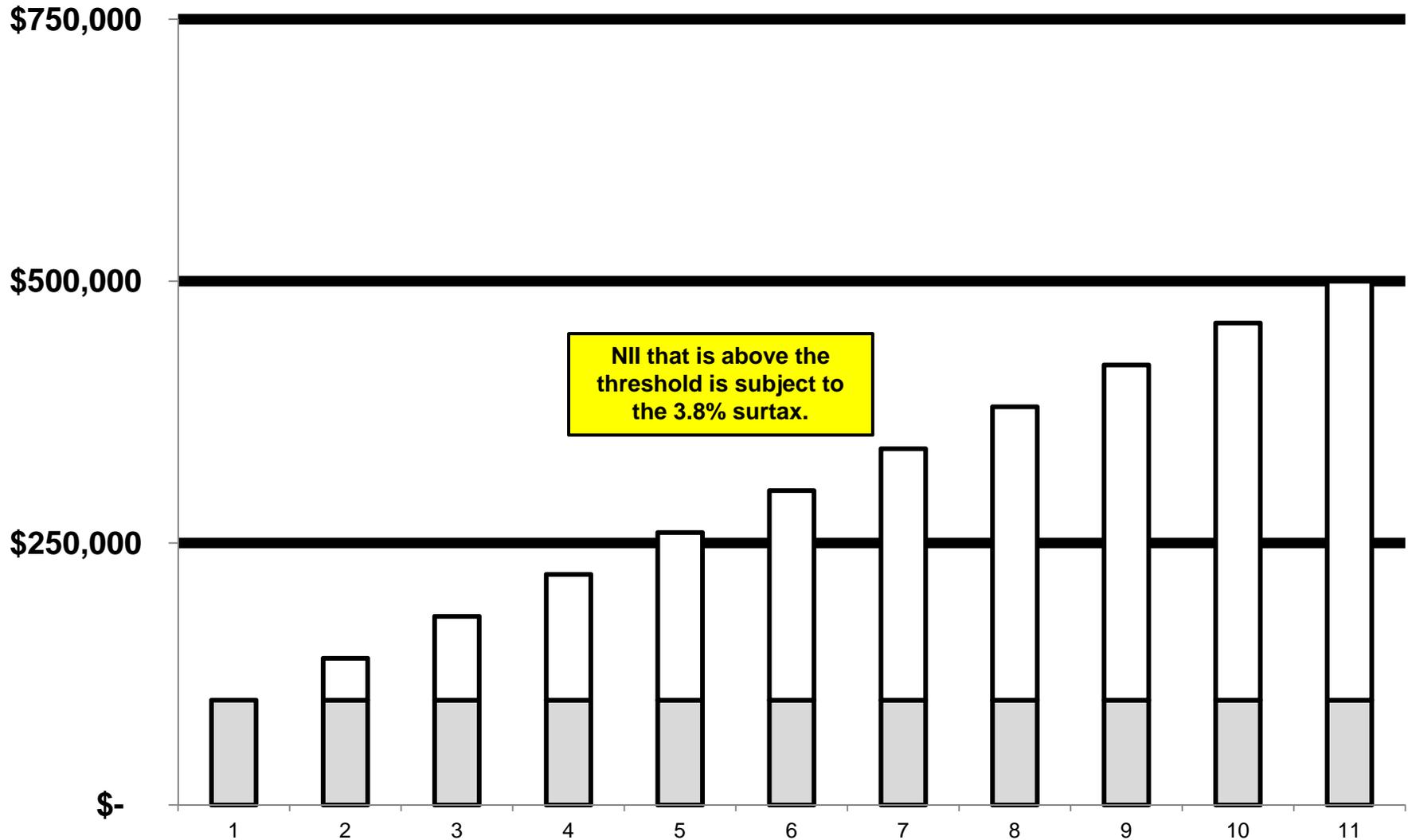
- **Results #1 - #4:** Until Other Income reaches a certain level, the 3.8% surtax is not triggered
- **Results #5 - #7:** There's a range of Other Income where every dollar of Other Income earned results in another dollar of NII being exposed to the 3.8% surtax.
 - **Example.** Beware of falling into this trap:
 - Question from client: "Is my RMD from a traditional IRA going to be subject to the 3.8% surtax?"
 - Answer: "No, it's not included in 'net investment income.'" While that is true, it omits a key feature of the surtax and so is misleading.
 - Better Answer: "The RMD itself is not 'net investment income.' However, it could cause more of your 'net investment income' to be exposed to the 3.8% surtax."
- **Result #8:** After a certain amount of Other Income, you have maxed out exposure to the 3.8% surtax.
 - **Example.** Husband and Wife have a fixed amount of NII. They both work and their combined salaries are \$250,000. That level of salary will push their NII fully above the threshold. They've already exposed 100% of their NII to the surtax.

The next slide reverses the prior chart as to which element is fixed and which is variable. It assumes:

- Your threshold is \$250,000;
- Your level of Other Income (still the shaded rectangle) is fixed at \$100,000. In the prior chart, Other Income varied.
- Your NII (still the white rectangle) will vary. In the prior chart, NII was fixed at \$100,000.

Other Income Fixed “Net Investment Income” Varies

■ Other Income = \$100,000 □ Investment Income



Takeaways from previous slide

- **Results #1 - #4**: Until NII reaches a certain level, the 3.8% surtax is not triggered
- **Results #5 and thereafter**. Unlike the prior chart, here every additional dollar of NII is another dollar exposed to the surtax, without limit.

III. Planning for individuals

The first step: confirm there’s a benefit to minimizing NII. From the examples above, it might not be an issue.

Tax Exempt Bonds

That will depend on a comparison of the after-tax yields of both. The after-tax yields of taxable bonds will now be affected by this additional 3.8% tax.

Minimize dividends

Dividends will now be taxed more heavily. This could encourage a preference for investments that generate capital appreciation. This could include non-dividend, or low-dividend, paying stocks and non-principal protected structured notes. Although the resulting capital gain would also be NII,

- only when the stock is sold (deferral); and
- can be offset by capital losses whereas dividends cannot.

Increase participation to make passive income non-passive. Gross income from a passive activity will be subject to the 3.8% tax. If your level of activity could be increased so that the business income becomes not passive, that would avoid the tax.

Review how your passive activities are aggregated. In determining whether you are active or passive in an “activity,” there are rules governing what constitutes an “activity” and how different activities might be combined and considered one single “activity.”

- Consult with tax advisor to see whether “activities” might be aggregated in a way that might minimize passive income.

Convert passive income to salary. Gross income from a trade or business that is a passive activity will be taxed as ordinary income and will also be subject to the 3.8% tax. If some of that income could instead be paid as compensation, that would seem to avoid the 3.8% tax.

- But beware payroll taxes:
 - 6.2% for Old-Age, Survivors, and Disability Insurance
 - The 6.2% has been reduced to 4.2% for employees for 2012.
 - 1.45% for Hospital Insurance. The \$110,100 wage base limit only applies to the first component; there is no cap for the 1.45%.
 - Beginning in 2013, this increases another 0.9% (to 2.35%) for income in excess of certain “high-income” thresholds.

Capital Loss Harvesting. U.S. Trust’s Tax Efficient Structured Equity (TESE) Program will now be more appealing.

Installment Sales. If the capital gain involved is NII, then spreading it out over multiple years might cause the 3.8% surtax to be less than if all of the capital gain were included in NII in the year of sale.

- Beware credit issues

Goal is not to reduce NII; the income described below is not NII. Rather, it's the second part of this tax – the excess of MAGI over the threshold – that's being minimized there.

None of these income-reducing ideas is new.

Schedule C income – Sole proprietor. Any expenses that would reduce the net income on Schedule C will reduce AGI and possibly the amount of income exposed to the 3.8% tax.

Schedule D - Capital gains. Harvesting losses would now save 23.8% (assuming long-term capital gain rate of 20% in 2013).

IRA distributions. These are not NII, but if taxable they will increase AGI, and so minimizing the income from IRA distributions could minimize the 3.8% tax. That could include the following:

- The Charitable IRA Rollover provision, if extended, would avoid having that amount in AGI. (As of this writing, this provision has not been extended beyond 2011.)
- This would be another factor in favor of a Roth conversion, which would have no income resulting from distributions.
- The conversion itself would be income, which suggests converting before 2013.

Schedule E – Income from rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.. Any expenses that would reduce the net income on Schedule E will reduce AGI and possibly the amount of income exposed to the 3.8% tax

Schedule F – Farming. Any expenses that would reduce the net income on Schedule F will reduce AGI and possibly the amount of income exposed to the 3.8% tax.

Above the line deductions. The following deductions would occur before determining AGI and therefore could reduce the income exposed to the 3.8% tax:

- Contributions to Health Savings Account;
- Contributions to self-employed retirement accounts;
- Contributions to a traditional IRA.

Itemized Deductions Irrelevant. Itemized deductions (e.g., charitable contributions, state taxes, interest) are taken into account after the calculation of AGI and so cannot affect AGI and will have no effect on the amount of income exposed to the 3.8% tax

- The next slide shows the first two pages of Form 1040. All items of income (box 1) and deductions (box 2) that are needed to calculate (M)AGI (box 3) come before itemized deductions (box 4).

Regular Income Tax: if a child has income that is subject to the kiddie tax, the child’s regular income tax is calculated based on what would be the parent’s incremental regular income tax, if the parent’s income were increased by the child’s investment income.

3.8% surtax: a child’s tax is calculated looking only at the child’s income. There is no surkiddie tax that would require that the child’s NII be subject to the 3.8% tax based on the parent’s 3.8% tax rate.

- This indicates the child’s threshold (\$200,000) would be fully available, even if parents’ threshold of \$250,000 has already been exceeded.

Election to include child’s income: If parent elects to include child’s investment income on parent’s return, the statute states that the child’s income “shall be included in such parent's gross income for the taxable year.”

- There’s nothing that limits this inclusion to the regular income tax
- It could also be included in parent’s income for purposes of the 3.8% tax.

Conclusions

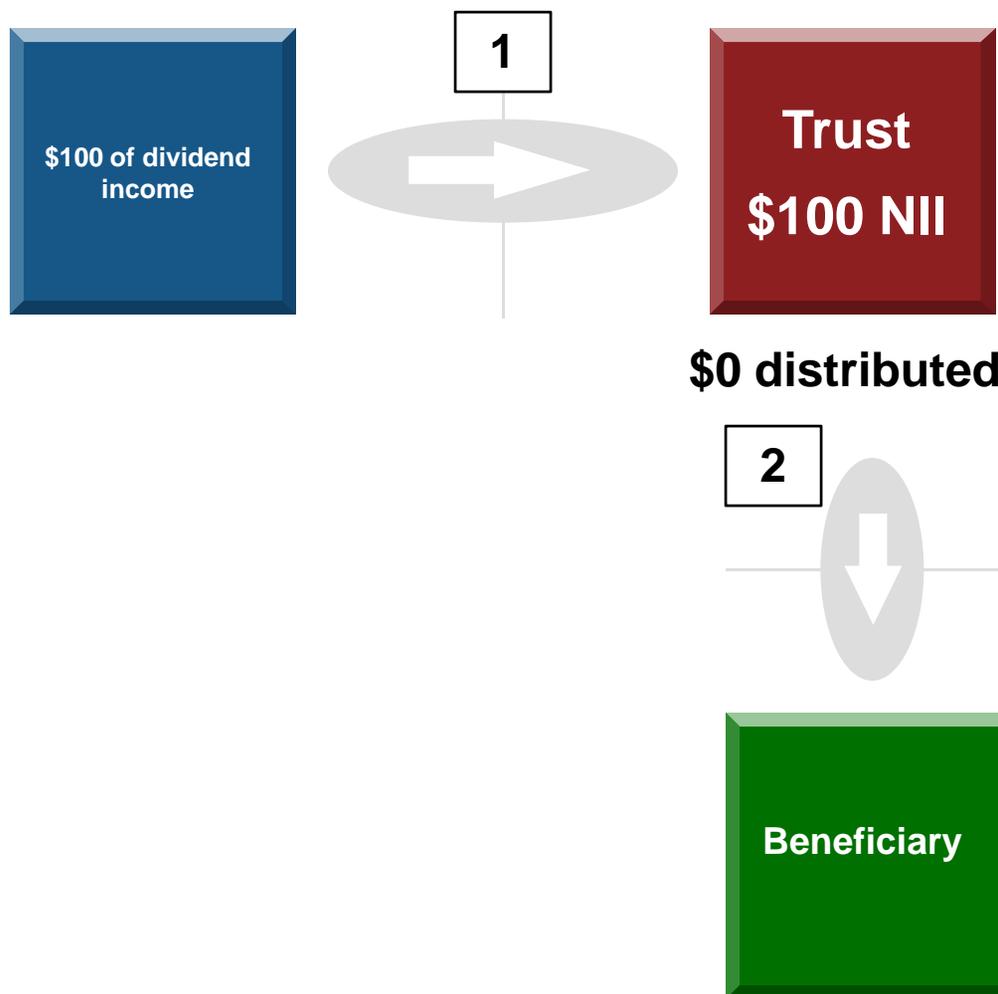
- Shifting investments from parent to child doesn't save regular income tax because of the kiddie tax.
- Making the election to include child's investment income on parent's return appears to also expose the child's NII to the parent's 3.8% tax.
 - Yet another reason this election might not be beneficial.
- Shifting investments from parent to child does appear to avoid the parent's 3.8% surtax and instead exposes the NII to the child's 3.8% surtax
 - Each child would have another \$200,000 threshold to work with

IV. Planning for Trusts and Estates

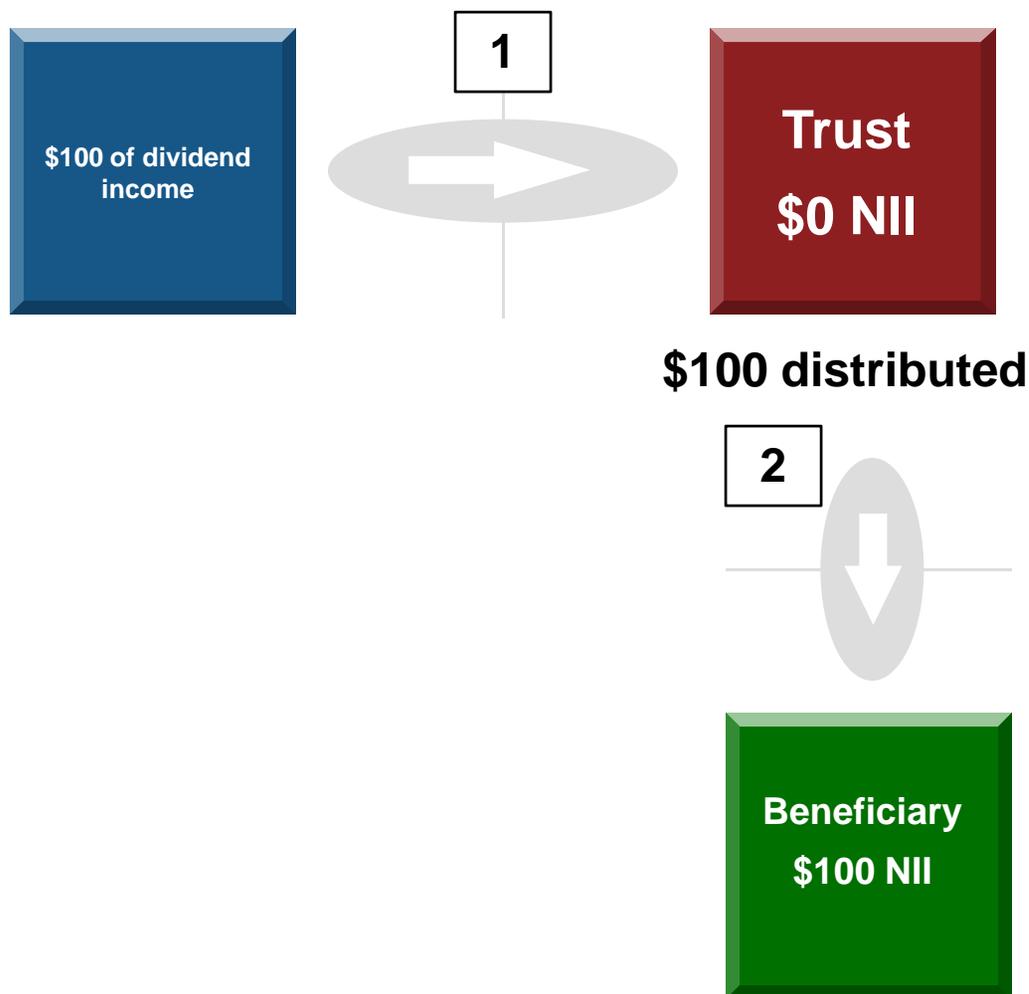
Planning for Trusts and Estates – “Undistributed NII” U.S. TRUST

- Very low threshold: app. \$12,000 for 2013.
- A trust is only subject to the 3.8 surtax on its “undistributed” NII
 - Consider a trust that receives a \$100 dividend (NII).
 - Whether that dividend is subject to the 3.8 surtax will depend (in part) on whether
 - The Trust distributes \$0 of that dividend (one extreme)
 - The Trust distributes \$100 of that dividend (the other extreme)
 - The Trust distributes more than \$0 but less than \$100 of that dividend (in between)

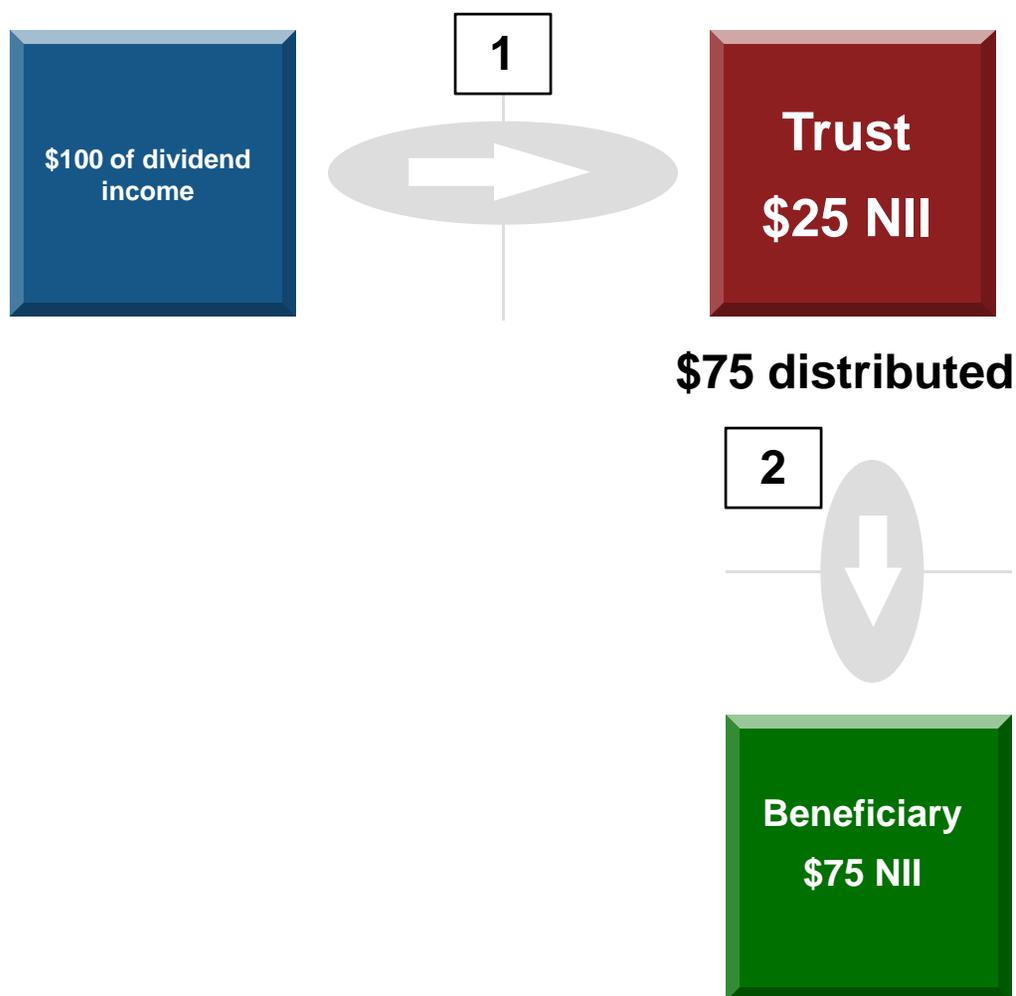
Trust receives \$100 dividend; distributes none.
Result: Trust has \$100 of NII



Trust receives \$100 dividend; distributes \$100.
Result: Bene has \$100 of NII



Trust receives \$100 dividend; distributes \$75.
Result: Bene has \$75 of NII; Trust has \$25 of NII

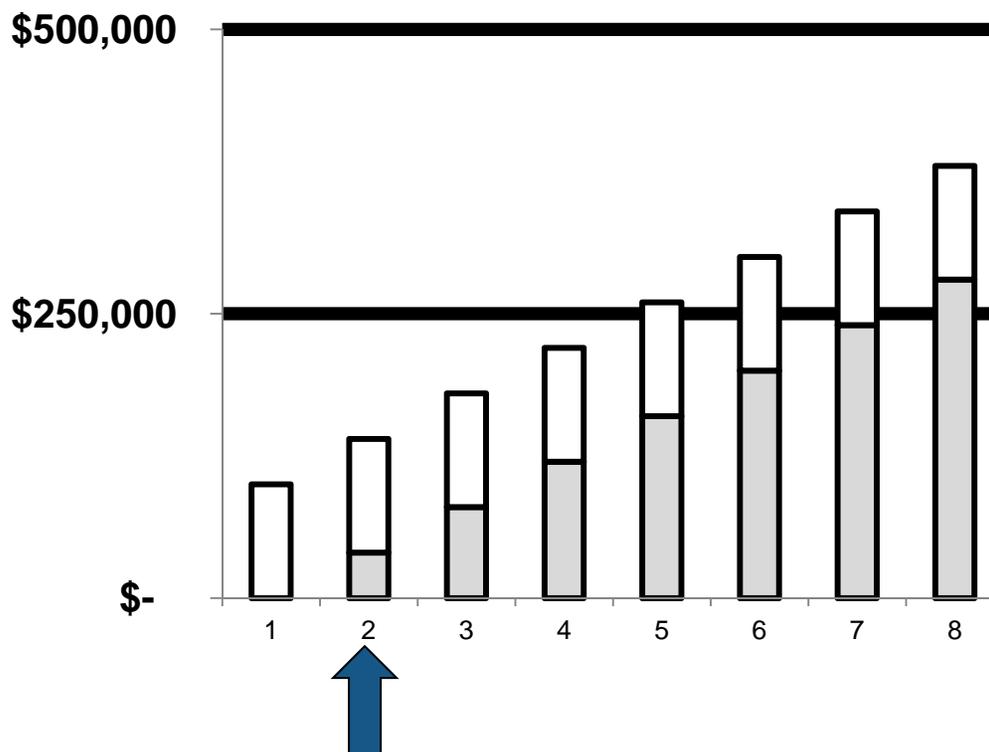


Planning for Trusts and Estates – low threshold

Given the very low threshold for trusts and estates, one planning consideration is to distribute NII to the beneficiaries if their higher Thresholds would result in less tax.

Of course, such distributions must be consistent with the terms of the trust and the trustee's fiduciary duties.

Example. Trust has NII of \$112,000, which is \$100,000 in excess of the threshold. Below is the chart from earlier. Assume a beneficiary's status is described by #2. That would mean that distributing that \$100,000 NII to the beneficiary would avoid the 3.8% surtax . . . but . . .



Beware unintended consequences

... beware unintended consequences. This would avoid 3.8% on the \$100,000, but it could have collateral effects to the recipient beneficiary. Below is a list (not exhaustive) of other matters that could be affected by increasing the beneficiary's income, which could more than offset the benefit of avoiding the 3.8% surtax.

- In 2013 the “Pease” limitations are scheduled to re-appear. These limitations phase-out the deductibility of itemized deductions and personal exemptions when AGI exceeds certain thresholds.
- The ability to contribute to a Roth is phased out as “modified” AGI exceeds certain thresholds. (The ability to “convert” a traditional IRA to a Roth is not affected by “modified” AGI.)
- The deductibility of contributions to a traditional IRA can be affected by AGI.
- Medicare premiums for Part B and D are increased when AGI exceeds certain limits
- The taxability of Social Security benefits is affected by AGI.
- Amounts that can be contributed to a Coverdell education savings account (formerly known as an Education IRA) are phased-out if “modified” AGI exceeds certain thresholds;

Beware unintended consequences – cont'd

- The interest income recognized on the redemption of EE bonds can be excluded from income if used to pay higher education expenses and if other requirements are met. This exclusion is phased-out if AGI exceeds certain thresholds.
- For regular income taxes, medical expenses are deductible as an itemized deduction only to the extent they exceed 7.5% of AGI. A distribution from a trust to avoid the 3.8% surtax would increase the recipient's "floor."
- For regular income taxes, "miscellaneous itemized deductions" are deductible only to the extent they exceed 2% of AGI. A distribution from a trust to avoid the 3.8% surtax would increase the recipient's "floor."
- Up to \$25,000 of passive losses from real estate can be deducted against non-passive income if you are "active" and other requirements are met. This exclusion is phased-out if AGI exceeds certain thresholds.

Such a distribution could also have a beneficial result from the increased AGI

- The ability to deduct charitable contributions as an itemized deduction is limited based on AGI. An increase in AGI could allow a larger charitable income tax deduction
- Investment interest is deductible only to the extent of “net investment income” (defined differently in that statute). A distribution of NII from the trust could allow a larger investment interest deduction.

Planning for Trusts and Estates

– distributions in kind as a tool

Assume trust distributions are discretionary. Trustee wants to make a \$100 discretionary distribution and owns stock with a value of \$100 and basis of \$75. Consider the following two choices.

Trust sells the stock and recognizes \$25 of capital gain. Trust distributes \$100.

- The \$25 of capital gain is recognized
- It will be NII to either the trust or the beneficiary

Trust distributes the stock in-kind.

- The \$25 of capital gain is not recognized, so the surtax NA
- The recipient will have a carryover basis of \$75.

Two caveats:

1. This is not necessarily a better tax result; it might be.
2. A distribution in-kind would trigger the built in gain if it was to satisfy a fixed obligation, such as a requirement to distribute all the income. So, this is limited to discretionary distributions.