The Health Care and Education Reconciliation Act's Tax on Net Investment Income

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One of the provisions included in the health care reform legislation enacted in 2010 will subject certain individuals to a 3.8% tax on net investment income (or "unearned income"). The new law is effective in 2013 and imposes a tax on "net investment income" when an individual taxpayer's modified adjusted gross income exceeds $200,000 for single filers and $250,000 for joint filers. The tax is equal to 3.8% of the lesser of the taxpayer's "net investment income" or the amount by which the taxpayer's modified adjusted gross income exceeds the threshold (i.e. $200,000 for single filers and $250,000 for joint filers).

Trusts and estates are also subject to the new tax. For trusts and estates, the tax is equal to 3.8% of the lesser of the trust's or estate's undistributed net investment income or the adjusted gross income in excess of the highest tax bracket on trusts and estates (i.e., approximately $12,000 for 2013).

Are there steps you can take to minimize this tax?

Yes. See below to learn how this tax may affect you and what you can do about it.

What is "net investment income" or "unearned income"?

Net investment income includes:

Interest, dividends, annuities, and royalties, less allocable deductions.

Net gain on the sale of property unless such property was held in an active trade or business, which is not a passive activity to the taxpayer.

Rents (less allocable deductions) unless the rents (i) are derived in the ordinary course of a trade or business and (ii) are not derived from a passive activity as to the taxpayer.

Income from any active trade or business if the activity is passive to the taxpayer.

Net investment income also includes the same categories of income described above if they are allocated to a taxpayer from a partnership or S corporation. Net investment income does not include distributions from qualified plans (e.g., individual retirement accounts and qualified pension, profit-sharing and stock bonus plans) or tax-exempt interest.

So, how does this new tax impact me?

If you have modified adjusted gross income in excess of the threshold amounts and net investment income, you will be subject to the new 3.8% tax. If you are a beneficiary of a non-grantor trust and the trust has undistributed net investment income in excess of the threshold, the trust will be subject to the 3.8% tax.

Unless you take advantage of tax planning opportunities that might be available to you, if you own real estate and lease that real estate (whether to an operating company owned by you or a third party), the rent you receive will be subject to the 3.8% tax unless such rent is "derived in the ordinary course of a trade or business" and the rent is not derived from a passive activity. If you have income from a passive activity, that income will likely be subject to the 3.8% tax.

Are there tax planning opportunities to minimize the impact of the new tax?

Yes, for some taxpayers it may be possible to minimize the 3.8% tax with careful tax planning. A few planning opportunities are highlighted below:

Planning opportunities exist when taxpayers own an interest in real property (directly or indirectly through a partnership, S corporation or trust) and lease that real property to an operating company owned by the taxpayers (directly or indirectly through a partnership, S corporation, or trust). Under this scenario, there may be several opportunities for restructuring the companies in a way to minimize the tax on rents for those taxpayers that materially participate in the business (i.e., the business is not a passive activity to the taxpayer).

Planning opportunities exist for trusts with undistributed net investment income and companies with excess cash that is invested and earns interest income, which will be subject to the 3.8% tax.

Planning opportunities also exist for those taxpayers planning to sell interests in partnerships, limited liability companies, and S corporations if they are actively involved in the business.

Who should I call?

If you are interested in learning how the new 3.8% tax will impact you or your business and how to minimize that impact, please contact Bill McNairy, Sara Vizithum or Susan Young.

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