

Family Tax Planning Forum

By Robert S. Keebler

Tax Planning for the New 3.8-Percent Medicare Tax

The Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) created a 3.8-percent tax, referred to as an Unearned Income Medicare Contribution Tax (UIMCT), on certain passive investment income of individuals, trusts and estates scheduled to begin in 2013. Until recently, it was not clear that the UIMCT would ever go into effect because of constitutional challenges to related legislation. The recent U.S. Supreme Court decision in *National Federation of Independent Business v. Sebelius*,¹ however, removed any doubt, making it important for high-income taxpayers to start their planning around the 3.8-percent UIMCT now. This column provides an overview of the new tax, explains how it is calculated and offers some planning strategies to reduce or eliminate exposure to the UIMCT.

Application of the Tax to Individuals

For individuals, the amount subject to the UIMCT is the lesser of (1) net investment income (NII), or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount (ATA).² These terms are explained below.

NII

NII is the sum of three categories of income reduced by deductions properly allocable to such income:

1. Gross income from interest, dividends, annuities, royalties and rents, unless such income is derived in the ordinary course of an active trade or business other than a securities or commodities business
2. Other types of gross income derived from (a) a trade or business that is a passive activity



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for the taxpayer under Code Sec. 469, or (b) a financial instruments or commodities business as defined at Code Sec. 475(e)(2)

3. Net gain (to the extent taken into account in calculating taxable income) attributable to the disposition of property other than property held in an active business that is not a securities or commodities business.³

Category 1

For individuals who are not engaged in a trade or business, all interest, dividend, annuity, royalty and rental income is subject to the UIMCT. For taxpayers engaged in an active trade or business other than a securities or commodities business, only nonbusiness income from these sources is included in NII. If the taxpayer is engaged in a passive trade or business or a securities or commodities business, both business and nonbusiness income from these sources is included in NII.

Category 2

Under the general rule of Code Sec. 469, a "passive activity" is defined as one in which the taxpayer does not materially participate,⁴ but there are two special rules. First, rental activities are treated as *per se* passive activities unless the taxpayer is a real estate professional.⁵ Second, working interests in oil and gas properties are *per se* nonpassive activities unless the taxpayer's form of ownership limits liability.⁶

Material participation means involvement in an activity on a regular, continuous and substantial basis.⁷ It must be shown by meeting one or more of the following tests:⁸

1. The individual participates in the activity for more than 500 hours during the tax year.
2. The individual's participation constitutes substantially all of the participation in such activity of all individuals, including nonowners.
3. The individual participates in an activity for more than 100 hours and no other individual participates more.
4. The activity is a significant participation activity for the tax year and the individual's aggregate participation in all significant participation activities is more than 500 hours.

5. The individual materially participates for any five years out of the immediately preceding 10-year period.
6. The activity is a personal services activity and the individual materially participated for any three previous tax years.
7. Based on all the facts and circumstances, the individual participates on a regular, continuous and substantial basis during the tax year.

For purposes of Test 4, significant participation activities are those in which a taxpayer participates for more than 100 hours but does not materially participate under any of the other six tests.⁹

The UIMCT could substantially increase the tax payable by many higher-income taxpayers.

Category 3

This category basically applies to certain capital gains. Specifying that capital gains are "net

gains" would seem to indicate that they can be offset by capital losses from the same tax year. It is not clear, however, whether capital loss carryovers from earlier years could also be used. Note also that net gain is subject to the UIMCT only to the extent it is taken into account in computing taxable income. This would exclude the following gains from the UIMCT:

- Gain on the sale of a principal residence up to the Code Sec. 121 exclusion amounts of \$250,000 for single taxpayers and \$500,000 for joint filers
- Gain on tax-free exchanges of insurance policies under Code Sec. 1035
- Gain excluded on like-kind exchanges under Code Sec. 1031
- Gain excluded on the sale of qualified small business stock under Code Sec. 1202

The statute specifically excludes from NII self-employment income¹⁰ and distributions from the following retirement plans:

- 401(a) (qualified pension, profit-sharing and stock bonus plans)
- 403(a) (qualified annuity plans)
- 403(b) (plans for employees of public schools and tax-exempt organizations)
- 408 (traditional IRAs)
- 408A (Roth IRAs)
- 457(b) (deferred compensation plans of state and local governments and tax-exempt organizations)

There is also a special rule for gain on the sale of an interest in a partnership or S corporation.¹¹ Under this rule, the UIMCT applies only to the portion of

the gain that would have been subject to the UIMCT if the partnership or S corporation had sold all its property for FMV immediately before the interest in the entity was sold. In effect, this limits application of the UIMCT to gains on nonbusiness assets.

MAGI

MAGI is adjusted gross income (AGI) increased by net foreign-source income exempt from regular tax under Code Sec. 911(a)(1). Since most taxpayers have no foreign source income, MAGI is generally the amount reported on line 37 of Form 1040.

ATA Amounts

The applicable threshold amounts are as illustrated in Table 1.

Table 1.

Married taxpayers filing jointly	\$250,000
Married taxpayers filing separately	\$125,000
All other individual taxpayers	\$200,000

Application of the Surtax to Trusts

For a trust or estate, the UIMCT payable is 3.8 percent of the lesser of (1) undistributed net investment income, or (2) the excess of AGI over the amount at which the top income tax bracket for trusts and estates begins. The highest bracket started at \$11,200 for 2010 when the law was enacted, but will be indexed for inflation. Most planners expect the amount to be approximately \$12,000 for 2013 when the UIMCT goes into effect.

The UIMCT presumably will not apply to grantor trusts or to simple trusts. A grantor trust is treated as owned by the grantor for income tax purposes and all items of trust income, loss, credit and deduction are reported by the grantor on the grantor's Form 1040. Thus, the trust would have no income to which the UIMCT could apply. A simple trust is one that is required to distribute all income to its beneficiaries annually. Because all income would be distributed there could be no undistributed net income subject to the tax.

Calculating the Tax Payable

Calculation of the UIMCT payable is best explained through a series of examples.

Example 1. Walt, a single taxpayer, has \$100,000 of salary income and \$80,000 of NII in 2013. The UIMCT applies to the lesser of NII (\$80,000) or the excess of Walt's MAGI over his ATA (\$0). (Note that there can never be any UIMCT unless MAGI exceeds the applicable threshold amount.)

Example 2. Hal and Rose, married taxpayers filing jointly, have \$2 million of salary income and no NII. The UIMCT applies to the lesser of NII (\$0) or the excess of \$2 million over their ATA (\$1.75 million). (The point here is that regardless how high MAGI might be, there cannot be a UIMCT without NII present.)

Example 3. Sam and Jill, married taxpayers filing jointly, have \$200,000 of salary income and \$150,000 of NII. The amount subject to the UIMCT is the lesser of NII (\$150,000) or the excess of MAGI over their ATA (\$100,000). Thus, the amount subject to the tax is \$100,000 and the UIMCT payable is \$3,800 ($0.038 \times \$100,000$).

Example 4. Wilma, a single taxpayer, has \$140,000 of salary income, \$35,000 of royalties, \$25,000 of taxable interest income, \$40,000 of tax-exempt interest, a \$25,000 distribution from a Roth IRA, a \$60,000 distribution from a traditional IRA and a \$50,000 gain from the sale of an interest in an active business in 2013. Wilma's NII is \$60,000 (\$35,000 royalties + \$25,000 taxable interest income). Her MAGI is \$310,000 (\$140,000 salary + \$25,000 taxable interest income + \$35,000 royalties + \$60,000 traditional IRA distribution + \$50,000 gain on the sale of the business interest). The UIMCT applies to the lesser of NII (\$60,000) or the excess of MAGI over ATA (\$110,000). Thus, the UIMCT payable is $0.038 \times \$60,000 = \$2,280$. Note that the tax-exempt interest and Roth IRA distribution are neither NII nor MAGI, the royalty income, and taxable interest income are both NII and MAGI and that the salary income, traditional IRA distribution and gain from the sale of the business are MAGI but not NII.

Example 5. Jack's estate received \$16,000 of dividends in 2013 and made no distributions.

Assuming a \$12,000 threshold amount for trusts and estates in 2013, the amount subject to the UIMCT is \$4,000 (\$16,000 – \$12,000) and the tax payable will be \$152 ($0.038 \times \$4,000$).

Example 6. Assume the same facts as in Example 5 except that all the estate income was distributed. Under these facts, the income will be reported to the heirs and there will be no UIMCT exposure for the estate.

Planning Strategies

Fortunately, there are a number of effective strategies that can be used to reduce MAGI and/or NII and decrease the base on which the UIMCT is paid. These include (1) tax-exempt bonds, (2) tax-deferred annuities, (3) life insurance, (4) oil and gas investments, (5) timing estate and trust distributions, (6) Roth IRA conversions, (7) charitable remainder trusts, (8) installment sales, (9) maximizing above-the-line deductions, and (10) accelerating 2013 income into 2012.

Tax-Exempt Bonds

Interest income generated on corporate bonds is both NII and MAGI, while interest income generated on tax-exempt bonds is neither. So, taxpayers may be able to save on the UIMCT by switching investment funds from corporate bonds to tax-exempt bonds. Because tax-exempt bonds generally pay a lower interest rate, however, taxpayers should ensure the tax savings is not outweighed by the reduced yield.

Tax Deferred Annuities

Buying a tax-deferred annuity can reduce the UIMCT by moving NII and MAGI from high-income years to lower-income years when the UIMCT won't apply. Suppose, for example that a taxpayer has NII and his MAGI is above the threshold amount in 2013, but he expects to have MAGI well below his ATA when he retires. A deferred annuity might be used to move NII and MAGI to later years when it won't produce any UIMCT.

Life Insurance

A similar income-smoothing result can be achieved with a whole life insurance policy. By purchasing the policy, the taxpayer can reallocate money from assets producing current NII and/or MAGI to assets

that are creating neither. The taxpayer could then withdraw earnings from the policy in lower-income years in the future when they won't be subject to the UIMCT.

Oil and Gas Investments

The intangible drilling costs associated with working interests in an oil or gas well can produce upfront deductions of up to 80 percent of the amount invested. This large deduction can be used to substantially reduce MAGI and NII for a high income year.

Timing of Estate and Trust Distributions

For trusts and estates, the UIMCT applies to the lesser of (1) undistributed net investment income, or (2) the excess of AGI over the amount of income where the highest tax bracket begins (assume \$12,000). If the beneficiaries of an estate or trust would not be subject to the UIMCT on distributions, UIMCT could be saved by distributing enough of the trust or estate's net income to reduce an estate or trust's undistributed income below \$12,000.¹²

Roth IRA Conversions

By doing a Roth IRA conversion in 2012, taxpayers can avoid all UIMCT on future IRA distributions. Consider the following example.

Example 7. Curt is a single taxpayer with \$200,000 of NII and distributions of \$100,000 per year from his traditional IRA. If he leaves the assets in the traditional IRA, his NII for 2013 and subsequent years will be \$200,000 and his MAGI will be \$300,000. Thus, he will pay UIMCT on \$100,000 of income each year during retirement. If Curt does a Roth IRA conversion in 2012, he can convert the \$100,000 traditional IRA distributions that are included in MAGI to \$100,000 Roth distributions that are not included in MAGI, reducing his MAGI to \$200,000 and eliminating the UIMCT. This would save John \$3,800 each year beginning in 2013. (Note that there is also no UIMCT on the conversion because the tax does not apply in 2012.)

Before deciding to do a current Roth conversion, however, taxpayers should do a comprehensive mathematical analysis to make sure it provides an overall economic benefit.

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the allowance for depletion and without the deduction under Code Sec. 199.

¹⁶ Reg. §1.199-4.

¹⁷ *Shell Oil Co.*, CA-5, 92-1 USTC ¶50,092, 952 F.2d 885 (1992). This was a windfall profit tax case where the taxpayer paid less excise tax on properties with low taxable incomes as computed under Code Sec. 613(a) but with certain adjustments. The court allowed Shell to apportion losses from abandoned G&G on nonproducing properties to its producing properties. This

was an apportionment method for G&G that the IRS adopted for the percentage depletion taxable income from the property limitation computation in June 1941 and quickly abandoned in October 1941. GCM 22689, 1941-1 CB 225, *superseded by* GCM 22956, 1941-2 CB103, *obs.* Rev. Rul. 68-661, 1968-2 CB 607. The IRS has not stated that it would follow the decision in *Shell* or readopt the allocation methodology of GCM 22689.

¹⁸ Reg. §1.1254-2(d)(1).

¹⁹ Property such as a pipeline that has been depreciated under Code Sec. 1245 but that is real property for Code Sec. 1031 purposes can be like kind to other real property (that is not depreciable under Code Sec. 1245); however, in those cases, the recapture rules will override the Code Sec. 1031 deferral and the Code Sec. 1245 potential recapture can be triggered. Reg. §1.1245-2(c)(4).

²⁰ Code Sec. 168(i)(7).

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Charitable Remainder Trusts

Charitable remainder unitrusts (CRUTs) and charitable remainder annuity trusts (CRATs) are exempt from tax under Code Sec. 664(c). This means that if a taxpayer contributes appreciated capital assets to a CRT, the trust can sell the assets without recognizing gain. The sale does not increase the donor's current year MAGI or NII. The taxpayer would only have income as the unitrust or annuity payments were received from the CRT. This might enable the taxpayer to spread out MAGI so that it didn't exceed the threshold amount in any given year.

Installment Sales

These can be used to spread out net investment income and MAGI in much the same manner as with a charitable remainder trust. They may enable a taxpayer to avoid UIMCT exposure in the year of sale and in subsequent years.

Above-the-Line Deductions

Deductions that can be claimed on the front page of Form 1040 reduce MAGI. Two of the more common deductions are contributions to qualified plans and traditional IRAs.

Accelerating Income

If possible, it might make sense to accelerate 2013 income into 2012 to reduce 2013 MAGI or NII. It is important to point out, however, that the time value of money must be considered. Taxpayers should analyze the tradeoff between paying less tax and paying it earlier.

Conclusion

The UIMCT could substantially increase the tax payable by many higher income taxpayers. Because some of the key UIMCT planning strategies require action in 2012, taxpayers should take action now.

ENDNOTES

¹ *National Federation of Independent Business*, SCt, 2012-2 USTC ¶50,423 (2012).

² Code Sec. 1411(a)(1).

³ Code Sec. 1411(c).

⁴ Code Sec. 469(c)(1).

⁵ Code Sec. 469(c)(2) and (7).

⁶ Code Sec. 469(c)(3)(A). Liability would be limited, for example, if the taxpayer owned a limited partnership interest, an interest as a nonmanaging member in an LLC or stock in an S corporation.

⁷ Code Sec. 469(h).

⁸ Reg. §1.469-5T(a).

⁹ Reg. §1.469-5T(c).

¹⁰ Code Sec. 1411(c)(5).

¹¹ Code Sec. 1411(c)(4).

¹² This assumes, of course, that the trust is not a grantor trust or a simple trust.

was payable quarterly irrespective of the earnings of HC and had a floating rate tied to market interest rates. Default of payment of interest was enforceable by the noteholders against HC. Moreover, HC was not thinly capitalized and had a debt-to-equity ratio within industry norms. Finally, the stock to be received by a noteholder upon maturity was equal to the principal amount of the Note and was not a fixed amount of stock. Thus, the IRS determined that the notes were debt for U.S. federal income tax purposes and interest paid thereon was deductible.

⁶ In *Monan Railroad*, *supra* note 4, the corporation retired its Class A stock by issuing 50-year, six-percent income debentures plus one-half share of Class B common stock for each share of Class A stock to its Class A stockholders. The question presented to the Tax Court was whether or not the debentures represented debt for U.S. federal income tax purposes. The Tax Court determined that, considering all facts, the debentures were in substance debt. The Tax Court noted that the corporation was amply capitalized, its stock was widely held, the parties to the transaction consistently treated the debentures as debt, the debentures had a fixed maturity date (even though redeemable at an earlier date), the issuance of the debt decreased the Class A stockholders' ability to participate in the growth of the corporation, the issuance of the debentures had a *bona fide* business purpose, and the debenture holders had a right to receive interest only restricted as to income earned by the corporation.

⁷ Notice 94-47, 1994-1 CB 357.

⁸ *Alterman Foods, Inc.*, CA-5, 75-1 USTC ¶9151, 505 F.2d 873 (1974).

⁹ Consider an entity that is a limited liability company that is disregarded from its corporate parent for federal tax purposes. If that subsidiary borrows, on open intercompany advances, from its sister corporation, the reclassification of this debt to equity means it has two owners for federal tax purposes and, thus, it is a partnership that should be filing a Form 1065.

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held and not in proportion to HC's stock, and were designated by the parties as debt in the offering documents. Interest