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Neil E. Harl
Iowa State University

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Proposed Regulations for the Unearned Income Medicare Tax

-by Neil E. Harl*

One of the revenue offsets in the Patient Protection and Affordable Care Act\(^1\) was the imposition of an unearned income Medicare tax\(^2\) after 2012 on couples filing a joint return or a surviving spouse who earns more than $250,000 ($125,000 for married taxpayers filing separately) and $200,000 for other taxpayers.\(^3\) The tax is imposed at a rate of 3.8 percent of the lesser of the taxpayer’s “net investment income” or the excess (if any) over the modified adjusted gross income for the taxable year over the threshold amount.\(^4\) On December 5, 2012, the Department of the Treasury released proposed amendments to the regulations that provide guidance for individuals, estates and trusts.\(^5\)

**Definition of “net investment income”**

The statute defines “net investment income” as the excess of the sum of gross income from interest, dividends, annuities, royalties and rents, other than such income derived in the ordinary course of a trade or business; other gross income derived from a trade or business which is a passive activity or a trade or business of trading in financial instruments or commodities; and the net gain attributable to the disposition of property, other than property held in a trade or business which is not a passive activity, in excess of the individual’s modified adjusted gross income for the taxable year over the threshold amount.\(^6\) The term also includes gains from the disposition of interests in a partnership or S corporation but only to the extent of the net gain which would be taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest.\(^7\)

Modified adjusted gross income is defined as the adjusted gross income increased by the excess of (1) the amount excluded from gross income under I.R.C. § 911(a)(1) (foreign earned income) over the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under I.R.C. § 911(d)(6) (denial of double benefits) with respect to the amount excluded from gross income as foreign earned income.\(^8\)

The term “net investment income” includes cash rents and, it appears, non-material participation share rents as well as noted in more detail below.\(^9\) The term does not include distributions from qualified retirement plans.\(^10\)

The tax applies to trusts and estates at the same rate, based on the lesser of the undistributed net investment income for the taxable year or the excess of the adjusted gross income over the dollar amount at which the highest tax bracket begins for the taxable year.\(^11\) The tax does not apply to non-resident aliens or to trusts all of the unexpired interests in which are devoted to one or more specifically designated charitable purposes.\(^12\) A bankruptcy estate of a debtor who is an individual who files under chapters 7 or 11 (and is eligible for new tax entity status) is treated as an individual for purposes of computing the 3.8 percent tax.\(^13\)

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*Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
Because of the Bankruptcy Tax Act of 1980, consistent with I.R.C. § 1398, regardless of the actual marital status of the debtor, a bankruptcy estate of the debtor who is an individual is treated as a married taxpayer filing separately for purposes of the thresholds; the threshold amount is $125,000.

The regulations governing the tax provisions are generally effective for taxable years beginning after December 31, 2013. Rents

The term “rents” is defined as the amounts paid or to be paid principally for the use (or the right to use) tangible property. The proposed regulations specify that “net investment income” does not include any item “taken into account” in determining self-employment income for the taxable year in which a 3.8 percent tax is imposed. The proposed regulations provide that “items taken into account” mean income included and deductions allowed in determining net earnings from self-employment for purposes of determining self-employment income. However, the term does not include amounts excepted from net earnings from self-employment under subsections 1402(a)(1) through 1402(a)(17). The reference below to the more demanding definition of “material participation” (on a regular, continuous, and substantial basis) suggests that participation under leases meeting the less demanding test of “material participation” for social security (and other) purposes may not rise to the level of material participation for passive activity purposes. Nonetheless, the statute makes it clear that “net investment income” shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b). Therefore, material participation share leases which involve payment of self-employment tax should not be subject to the tax on net investment income.

Nonetheless, for purposes of the 3.8 percent tax, a taxpayer must determine whether a trade or business (using the I.R.C. § 162 guidelines) is a passive activity. The term “passive activity” has the same meaning as in I.R.C. § 469. Thus, the test is whether there is market participation on a regular, continuous and substantial basis. If that more demanding material participation test is met, the income is not considered passive and losses are allowed. Other than for the special rule for taxpayers in a “real property business,” rental activities are included in the term “passive activity.” That apparently means that those failing to meet the test of material participation on a “regular, continuous, and substantial” basis are subject to the 3.8 percent tax. That would appear to mean that cash rents as well as non-material participation share rents are subject to the 3.8 percent tax. Indeed, it could mean that even some material participation share rents could be subject to the tax where the involvement under the standard meaning of “material participation” falls short of material participation on a “regular, continuous, and substantial basis.” However, payment of self-employment tax on rents shields such rental income from the tax on net investment income.

Disposition of interests in partnerships and S corporations

In most instances, interests in a partnership or S corporation are not property held in a trade or business so gains and losses from the sale of a partnership interest or S corporation stock are subject to the 3.8 percent tax. In a disposition of an interest in a partnership or stock in an S corporation, gain from the disposition is taken into account only to the extent of the net gain which would be taken into account if all property in the partnership or S corporation were sold for fair market value immediately before the disposition of the interest. The Congressional intent was that a transferor of an interest in a partnership or of the stock in an S corporation would be in a position similar to where the entire partnership or S corporation had disposed of all of its properties with the gain or loss passed through to its owners (including the transferor). Keep in mind that these rules would appear not to apply to entities where the “partnership” is within the “small partnership” exception. This possibility is not mentioned in the proposed regulations but, as noted above, the individual partners could be subject to the tax.

Installment sales

In the case of a disposition of an interest in a partnership or stock in an S corporation in an installment sale transaction, the proposed regulations specify that the adjustment to net gain is to be calculated in the year of disposition. The gain and any adjustment are deferred and recognized proportionally under I.R.C. § 453. In the event the year of the disposition occurs before the effective date of the proposed regulations, these adjustments are not applicable unless elected to apply. In general, the income tax gain and loss rules, including deferral provisions such as installment sales, like-kind exchanges, involuntary conversions and the exclusion of gain from the sale of the principal residence, apply for purposes of determining net gain in figuring the 3.8 percent tax.

ENDNOTES


2 The amounts collected from the 3.8 percent tax apparently are not designated for the Medicare Trust Fund.

3 I.R.C. § 1411(b).

4 I.R.C. § 1411(b).


6 I.R.C. § 1411(c).

7 See I.R.C. § 1411(d).

8 I.R.C. § 1411(c)(4). Presumably, the tax is not imposed on individuals or entities who file under the “small partnership” exception of I.R.C. § 6231(a)(1)(B) but would be imposed on the individual “partners” of such a small partnership. See Harl, “Where Would the “Small Partnership” Exception Be Advantageous?” 23 Agric. L. Dig. 185 (2012); Harl, The ‘Small Partnership’ Exception: A Way to Escape Partnership Tax Complexity,” 23 Agric. L. Dig. 1 (2012).

9 I.R.C. § 1411(d).

10 See I.R.C. § 1411(c)(1)(A)(i) (the test is I.R.C. § 469).

11 I.R.C. § 1411(c)(5).

12 I.R.C. § 1411(a)(2).

13 I.R.C. § 1411(e). See I.R.C. § 170(c)(2)(B) (“...a corporation, trust or community chest, fund or foundation...organized and
failed to show that the taxpayer had sufficient reasonable expenses that prevented the taxpayer from making at least some payment of the assessed taxes. In re Rossman, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,713 (Bankr. D. Mass. 2012).

The debtor hired a company to handle its payroll, including payment of federal taxes withheld from the employees’ wages. Although the debtor was required to pre-pay the amounts to be paid as wages and as withheld taxes, the debtor was behind in several months of payments when the debtor filed for bankruptcy. The payroll company sought to have the unpaid amounts declared nondischargeable under Section 523(a)(14) as a debt incurred to pay federal taxes which would otherwise be nondischargeable. The court held that Section 523(a)(14) did not apply because the payroll company incurred the debt voluntarily, the debt was largely for payment of the wages, and the debtor did not incur the debt as part of an effort to pay the taxes. The court also held that Section 523(a)(14) did not apply because the taxes involved were not nondischarble because the taxes were actually paid, leaving no tax claim against the debtor. In re Provenzano, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,694 (Bankr. E.D. Mich. 2012).

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor owed taxes resulting from stock options received as part of compensation from employment. Although the debtor had lived an expensive lifestyle in the taxable year which gave rise to the taxes, the debtor had not realized the large tax debt which would result from the sale of the stock options and had thought that subsequent losses would offset the taxable income. However, once the tax debt was known, the debtor stopped the expensive lifestyle and made several changes to reduce costs, including moving to another country. The court noted that none of the usual indicia of tax evasion was present, including no attempt to hide assets, continue a lavish lifestyle or retain expensive assets. The court held that the taxes were not nondischargeable under Section 523(a)(1)(C) because of failure of the IRS to show willful intent to evade taxes. On appeal the appellate court affirmed, agreeing that the debtor had a bona fide, but mistaken belief that later losses would offset the taxes incurred from the sale of stock. In re Lindros, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,703 (M.D. Fla. 2012), aff’d, 2011-2 U.S. Tax Cas. (CCH) ¶ 50,712 (Bankr. M.D. Fla. 2011).

The debtor had invested in a couple of farm tax shelter partnerships and incurred taxes from disallowance of the deductions resulting from the partnerships. Although their was no evidence of direct attempts to evade payment of the taxes, the court held that the taxes were nondischargeable because the debtor, a lawyer, had knowledge of the duty to pay taxes and had the ability to make payments from substantial income. The court noted that the debtor

FEDERAL FARM PROGRAMS

No items.