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McKenna Long & Aldridge LLP

Tax Advisory

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More About the Medicare Tax on Net Investment Income

In an advisory issued **last month,** we generally described the new Medicare tax under Section 1411 of the Internal Revenue Code which applies beginning January 1, 2013 and is equal to 3.8% on the "net investment income" of U.S. individuals, estates and trusts (the "MTNII"). It will apply to the *lesser* of: (i) an individual's net investment income, or (ii) the excess, if any, of the individual's modified adjusted gross income[1] over a threshold amount ($250,000 for joint filers, $125,000 for married persons filing separately and $200,000 in all other cases). Effectively, the MTNII will not apply to an individual who has modified adjusted gross income which is less than the threshold amount. This advisory focuses on certain other aspects of the MTNII.

Trusts and Estates

For a trust[2] or an estate, the MTNII is equal to 3.8% of the *lesser* of: (i) "undistributed net investment income", or (ii) the excess, if any, of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to a trust or estate begins (for 2012, the highest trust and estate income tax bracket begins at $11,650). As with individuals, those trusts or estates which become subject to the MTNII must comply with the quarterly estimated tax provisions applicable to individuals. Because the amount by which the threshold highest income tax bracket increases every year is small and the threshold is low, if trusts and estates have any significant net investment income, they will likely be subject to the MTNII.

It would appear that Section 1411(a)(2) was not intended to apply to estates and trusts if they were required to distribute, and in fact distributed, all of their taxable income annually to their respective beneficiaries (sometimes referred to as a "simple" trust). Instead, it appears that the MTNII applies only to those estates and trusts that are not required to distribute all of their taxable income annually (sometimes referred to as a "complex" trust). The MTNII provisions should recognize that "undistributed net investment income" would reflect a reduction for all the payments and distributions made by the estate or trust to their non-charitable beneficiaries. However, Section 1411 contains no definition of "undistributed net investment income."

Further, because "net investment income" includes income or gain from a trade or business that is a passive activity (within the meaning of Section 469 of the Code), those trusts and estates that generate such passive income (over the annual threshold tax bracket amount discussed above) will likely be subject to the MTNII. However, such passive income would not be included in

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"net investment income" if the trust or estate "materially participates" in a passive activity within the meaning of Section 469. Unfortunately, the existing Section 469 regulations have yet to provide any rules on determining "material participation" of trusts and estates. One of the principal IRS authors of the proposed regulations under Section 1411 has indicated that this uncertainty will likely not be cleared up by the promulgation of such regulations.[3]

That being said, it is clear that the MTNII will *not* apply to:

- a trust exempt from income tax under Section 501 of the Code;
- a trust all the unexpired interests in which are devoted to one or more Section 170 charitable purposes; or
- a charitable remainder trust exempt from income tax under Section 664 of the Code.

Further, net investment income excludes any distributions from certain trusts, plans or other arrangements such as qualified retirement plans, Section 403(b) plans and IRAs.

The Need for IRS Guidance

Given the individuals and the various types of entities potentially subject to the MTNII, coupled with the breadth of this new tax, it has been reported that nearly every division of the IRS has in some way been involved in the drafting of the forthcoming proposed regulations covering the MTNII under Section 1411. As noted above, Section 1411(a)(2) does not define the term "undistributed net investment income" for estates and non-grantor trusts and there is uncertainty about exactly what was intended by the drafters. Additional uncertainty is presented as to whether the net investment income of a non-grantor trust or an estate includes the amount of net capital gain that is distributed by such trust or estate to its beneficiaries. Further, it is also not clear whether the term "undistributed net investment income" includes amounts paid by a non-grantor trust or an estate to a charitable organization or set aside for a charitable purpose. This list of uncertainties within Section 1411 goes on and on.

A number of other issues raised under Section 1411 as it applies to individuals will also need to be addressed by such proposed regulations. Perhaps the most complicated issues will be how the various passive activity rules under Section 469 of the Code will interact with the determination of what amounts of passive income (after the deductions "properly allocable" thereto are taken into account) from a passive activity will be included in the individual's net investment income for MTNII purposes.

This will apparently include whether and how the MTNII applies to the income attributable to the "carried interest" of a typical investment partnership (i.e., a typical private equity, venture capital, LBO, real estate or hedge fund). The proposed regulations may well indicate that the MTNII applies to the "carried interest" whether the investment partnership is a private equity fund that "invests" in stocks or securities for its own account or is a hedge fund that "trades" in stocks or securities for its own account. Here, in the context of the "carried interest" as opposed to an individual investor's investment in such investment partnership, the proposed regulations may also reflect that an individual's "material participation" in any trade or business of a managing member, general partner or any other affiliate that owns a direct or indirect interest in the carried interest is not relevant to the income attributable to such carried interest. (If this turns out to be the result under the proposed regulations, then it should be noted that such partial federal taxation of carried interests will have been accomplished irrespective of whether any of the various federal legislative proposals introduced in Congress which would tax the carried interest as service income for all federal income tax purposes will ever be passed into law.)

The proposed regulations will also have to address whether interest expense, current passive deductions, suspended passive losses and Section 469(g) losses triggered by the disposition of an interest in a partnership or S corporation are "properly allocable" for purposes of determining net investment income. Further, the proposed regulations will presumably also provide guidance concerning Section 1411(c)(4), which is discussed next below, and applies a "deemed sale approach" to determine the amount of net investment income from a disposition of an interest in a partnership or S corporation. Section 1411(c)(4) treats the net gain from the disposition of an interest in a partnership or in an S corporation in the same manner as if the partnership or S corporation had sold all its assets at fair market value (i.e., the "deemed sale approach") in order to calculate the gain on the seller's sales proceeds. While there is some existing IRS regulations authority concerning the application of a "deemed sale approach" to a disposition of a partnership interest,[4] exactly how this will apply to calculating the net investment income for MTNII remains unclear.

The promulgation of this Section 469-related MTNII guidance will require a new level of tax analysis regarding the consequences of participating in Section 469 passive activities.

The IRS has promised to issue the proposed regulations in the near future, with the goal of finalizing them (after a three month comment period by taxpayers) before the MTNII begins to apply beginning January 1, 2013. This effort combined with the likely required modification of the many affected IRS tax forms (at least two dozen according to the IRS at last count) will make the potential application of this MTNII a required addition to both basic transactional and year end tax planning for the potentially affected taxpayers.

1. Section 1411(d) provides that "modified adjusted gross income" means adjusted gross income increased by the amount excluded from income as foreign earned income under Section 911(a)(1) of the Code (net of the deductions and exclusions disallowed with respect to foreign earned income). Accordingly, for many individuals who will not have this adjustment, their "adjusted gross income" will also equal their "modified adjusted gross income."

2. Technically, this means an estate or non-grantor trust that is subject to the rules of subparts A through D of part 1 of subchapter J of chapter one of the Internal Revenue Code of 1986, as amended (sometimes referred to as "complex" trusts).

3. The IRS has, however, ruled privately on this issue. See Private Letter Ruling 20102904 (April 7, 2010) (the IRS ruled that the sole means for a trust to establish "material participation" is if its trustee is involved in the operations of the activity on a regular, continuous and substantial basis).

4. Section 1.751-1(a)(2) of the IRS regulations applies a deemed sale approach to the calculation of the amount of income or loss from the partnership's Section 751 property (depreciation recapture and appreciated inventory items) which recharacterizes a portion of the capital gain from the sale of a partnership interest as ordinary income.

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