CLIENT - ALERT



TO: Business Clients

FROM: D. Brent Wills, Esq.

RE: Health Reform Update: 3.8% Medicare Tax on Net Investment

Income

DATE: October 1, 2012

In the aftermath of the United States Supreme Court decision earlier this summer upholding the constitutionality of the majority of the Patient Protection and Affordable Care Act (the "Affordable Care Act," or the "Act"), and the related Health Care and Education Reconciliation Act of 2010 (the "Reconciliation Act"), employers and other business people are scrambling to determine exactly how the Act will impact (or is already impacting) them. Among its various mandates, requirements and other provisions, the Affordable Care Act and the Reconciliation Act make a number of important changes to the Internal Revenue Code (the "Code").

This Client Alert is focused on Section 1402 of the Reconciliation Act, which adds a new section, Section 1411, to the Code. This new section imposes a 3.8 percent (3.8%) Medicare tax on certain individual taxpayers' net investment income (so-called "unearned income"). The tax rate is equal to the 3.8% total Medicare tax rate now applicable to the same individual taxpayers' earned income, as the result of the additional 0.9 percent (.9%) Medicare hospital tax imposed in other sections of the Act.³ Section 1411 will apply with respect to tax years beginning after December 31, 2012.

As indicated above, the tax in Section 1411 applies only with respect to certain individual taxpayers, namely those individuals whose modified adjusted gross income ("AGI") in a given year exceeds (i) \$250,000, if the taxpayer files a joint federal income tax return with his or her spouse; (ii) \$125,000, if the taxpayer is married but files a separate return; or (iii) \$200,000, in any other case.⁴

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¹ Pub. L. 111-152. The full text of the Act may be accessed online at http://www.gpo.gov/fdsys/pkg/PLAW-111publ152.pdf.

² Pub. L. 111-148. The full text of the Reconciliation Act may be accessed online at http://www.gpo.gov/fdsys/pkg/PLAW-111publ148/pdf.

³ See Section 9015 of the Act. The existing Medicare tax rate for individual tax payers (including employer contributions) is 2.9 percent (2.9%).

⁴ See Section 1411(a)(1) and Section 1411(b) in the Reconciliation Act.

In addition, the tax applies only with respect to net investment income. "Net investment income" includes, generally, gross income from interest, dividends, annuities, royalties and rents, as well as net gain attributable to the disposition of property (i.e., taxable net capital gain).⁵ Net investment income does not include, however, a distribution from an employee benefit plan described in Section 401(a), Section 403(a), 403(b), 408, 408A or 457(b)⁶ or self-employment income subject to the Medicare tax under Section 1401(b) of the Code.⁷

Notwithstanding (i), with respect to gross income derived in the course of (a) a passive activity, within the meaning of Section 469 of the Code; or (b) trading in financial instruments or commodities, such gross income is subject to the tax in Section 1402, except gross income from interest, dividends, annuities, royalties, rents and net taxable capital gains.⁸

Note that section 1411 includes a number of exceptions and special rules regarding its application. For example:

- (i) *Exception for Investment of Working Capital.* Similarly to Section 469(e)(1)(B) in the Code, Section 1411 in the Reconciliation Act excludes from the new tax an individual's investment in the form of working capital.⁹
- (ii) *Disposition of an Interest in an S Corporation or Partnership*. The net gain subject to the tax imposed in Section 1411 in the Reconciliation Act in the event of the disposition of an individual's ownership interest in an S corporation or partnership will be the net gain attributable to the individual, if any, that would result if the S corporation or partnership, as the case may be, sold all its assets at fair market value immediately prior to such disposition. Note the tax does not apply if (i) the individual's ownership in the S corporation or partnership ownership was a passive activity, within the meaning of Section 469 of the Code; or (ii) the S corporation or partnership was engaged in trading in financial instruments or commodities.¹⁰
- (iii) Capital Gains / Sales of Residences. The new tax in Section 1411 does not apply to the sale of a primary residence, except in certain circumstances. As under current law, 11 the new tax will apply only (i) to an individual who sells a primary residence and meets one of the AGI thresholds set forth above; and (ii) to the extent the gain realized from the sale exceeds \$250,000, if the taxpayer is single, or \$500,000, if the taxpayer is married filing jointly. Note, however, that, again, as under current law, the exclusions applicable to the sale of a primary residence do not

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⁵ See Section 1411(c)(1) in the Reconciliation Act.

⁶ See Section 1411(c)(5) in the Reconciliation Act.

⁷ See Section 1411(c)(6) in the Reconciliation Act.

⁸ See Section 1411(c)(2) in the Reconciliation Act.

⁹ See Section 1411(c)(3) of the Reconciliation Act.

¹⁰ See Section 1411(c)(4) in the Reconciliation Act.

¹¹ See Section 121(b) in the Code.

apply to the sale of a vacation home or other residences; the new tax under Section 1411 would apply to the entire net capital gain, if any, that results from such a sale, if the taxpayer(s) meet one of the AGI thresholds set forth above.

This Memorandum merely provides an overview of the new Medicare tax under Section 1411. If you have specific questions regarding the tax, including whether or how it may apply to you, please feel free to contact any attorney in our <u>Taxation Practice Group</u>. ¹² You can reach us at (334) 244-1111.

PLEASE BE ADVISED: This Memorandum is intended only to provide an overview of the matters addressed herein and does not constitute legal advice. If you have questions regarding a specific taxation matter, please seek appropriate legal counsel.

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¹² For additional information regarding the Taxation Practice Group, please visit my firm's website, at http://gilpingivhan.com/practiceGroup/Taxation.