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Diagnosis and treatment: understanding and preparing for the new investment income tax

Recent health care legislation creates a new tax on investment income

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When President Obama signed the 2010 Health Care Reconciliation Act on March 30, 2010, substantial changes to the nation's health care policy became reality. To help fund these changes, the legislation calls for several tax increases in the coming years. Some of the more notable increases are an excise tax on so-called Cadillac health insurance plans, an increase in the Medicare wage tax paid by some workers and new restrictions on flexible spending accounts. In addition, the legislation adds a new tax on many types of investment income. When combined with rate increases already scheduled to occur, this new tax will result in a drastically higher tax burden on the investment income of many Americans. It is therefore important to understand the application of the new tax as well as planning opportunities that may be available to minimize the tax's impact.

Mechanics of the New Tax

The investment income tax is found in new Section 1411 of the Internal Revenue Code. The tax becomes effective in 2013 and applies to the "net investment income" of individuals with modified adjusted gross income ("MAGI")[1] in excess of certain thresholds.[2] The threshold is $250,000 for single taxpayers and $125,000 for married taxpayers filing separately. Because these thresholds are not indexed for inflation, the new tax will impact more taxpayers with each passing year. The tax is levied at the rate of 3.8 percent in addition to the income tax otherwise due under other provisions of the IRC.

The investment income tax does not apply to C corporations. Entities taxed as partnerships or S corporations are not directly impacted; however, the income passed through these entities to individual partners or shareholders may be subject to the tax. Additionally, the tax applies to trusts, as described more fully below.

The "net investment income" that is subject to the new tax includes:

- Interest
- Dividends
- Rents
- Royalties
- Annuity payments
- Capital gains
- Income from passive activities[3]
- Income from businesses trading in financial instruments or commodities[4]
- Income or gain on the investment of working capital

"Net investment income" is reduced by allowable deductions that are properly allocated to the income. Additionally, there are several important exceptions from the broad definition of "net investment income":

- Income from an active business other than a financial instruments or commodities trading business
- Gain on the disposition of property used in an active business other than a financial instruments or commodities trading business
- Gain or loss on the disposition of an active interest in a partnership or S corporation other than a financial instruments or commodities trading business[5]
- Distributions from retirement plans such as 401(k)s, 403(b)s, Section 457 plans, traditional IRAs,

and Roth IRAs
- Income subject to self-employment tax

The tax does not apply to income not otherwise taken into account in computing taxable income, such as excludable gain on the sale of a principal residence, gain deferred in a Section 1031 exchange and gain deferred in a corporate reorganization. Also, the investment income tax should not impact an Oklahoma taxpayer's eligibility for nontaxable treatment of gain on the sale of certain Oklahoma property for state income tax purposes.

The tax applies to the *undistributed* "net investment income" of trusts with MAGI above the amount marking the beginning of the highest rate applicable to trusts. This amount, which is indexed for inflation, stands at $11,200 in 2010.[6] Because grantor trusts are not recognized as entities apart from their owners for income tax purposes and because simple trusts distribute all income annually, only complex trusts – those that are separately regarded and accumulate income – are potentially subject to the investment income tax. Additionally, the tax does not apply to tax-exempt charities organized as trusts or to charitable remainder trusts.

Taxpayers, whether individuals or trusts, must take the new tax into account in calculating any required estimated payments.

Putting the investment income tax in perspective
Setting aside the new tax for the moment, tax rates are already scheduled to increase in 2011. At that point, the top ordinary income rate rises to 39.6 percent, and the long-term capital gains rate rises to 20 percent. In addition, the preferential treatment of qualified dividend income, currently taxed a the capital gains rate, is set to expire in 2011. Although President Obama has proposed limiting the rate on qualified dividends to 20 percent beginning in 2011, it is unclear whether Congress is inclined to pass the legislation necessary to implement this proposal.

When the investment income tax becomes effective in 2013, the federal rate paid by taxpayers in the top marginal bracket on items such as interest, rents, royalties, and possibly dividends will total 43.4 percent, a 24 percent increase over the 35 percent rate applicable in 2010. Many long-term capital gains will be subject to federal tax at a rate of 23.8 percent, representing a 59 percent increase over the current 15 percent rate.

Planning Opportunities
Several strategies for avoiding or minimizing the impact of the new investment income tax are readily apparent. These options include allocating investment funds to tax-exempt municipal bonds and increasing contributions to income tax-favored retirement plans. An additional strategy that may be appropriate for some taxpayers is accelerating the sale of low-basis capital assets – such as real estate or concentrated ownership of a business – to 2010, when neither the general rate increases nor the investment income tax is effective. Similarly, a taxpayer holding an installment note along with influence over the acceleration of the gain being deferred should consider the possibility of recognizing the gain in 2009.[7]

Finally, taxpayers should take another look at the attractiveness of converting a traditional IRA to a Roth IRA. The income limits on Roth conversions have been removed, and the taxable income resulting from a 2010 conversion may be recognized equally in 2011 and 2012.[8] Numerous factors are relevant to the decision whether to convert, including the age of the taxpayer, the taxpayer's likely future income level and the ability to pay the tax with assets outside the IRA. To these factors, we can now add another important consideration – the investment income tax. Neither distributions from traditional nor Roth IRAs are considered net investment income for purposes of the new tax. However, traditional IRA distributions increase MAGI. As a result, these distributions could trigger the imposition of the investment income tax on other investment income that otherwise would have escaped the tax because of the taxpayer''s MAGI in relation to the relevant threshold amount.[9]

As the 2013 effective date nears, new strategies for lessening the impact of the investment income tax are likely to evolve. For the time being, it is important to understand the new tax and to begin planning for a significantly higher tax burden on investment income.

Endnotes

1. *For purposes of Section 1411, MAGI is defined as adjusted gross income with further adjustments required for taxpayers claiming the foreign income exclusion.*
2. *To be precise, the tax applies to the lesser of (i) net investment income, or (ii) the excess of MAGI over the applicable threshold amount.*
3. *The characterization of income as active or passive is determined by the passive activity rules under Section 469.*
4. *In this context, a "commodity" is generally defined to include any commodity that is actively traded*

as well as derivatives and hedges with respect to the commodity.

5. *Where this exception applies, the tax is still imposed on any net investment income that would be recognized on a hypothetical sale of all assets of the partnership or S corporation immediately before the transfer of the interest in the entity.*
6. *More precisely, the tax applies to the lesser of (i) a trust's undistributed net investment income, or (ii) the excess of the trust's MAGI over $11,200 in 2010.*
7. *This situation may exist in the case of an installment note received in an intra-family sale of interests in a family limited partnership or an operating defective grantor trust.* business to an intentionally
8. *Because ordinary income rates at the top of the rate schedule are set to increase in 2011, this two-year deferral would be detrimental to some taxpayers and should be studied carefully.*
9. *Consider a married couple filing jointly. In 2013, the couple has pension income of $150,000, net investment income of $100,000, and $125,000 in required minimum distributions from traditional IRA's. The couple's MAGI is $375,000, and they must pay an investment income tax of $3,800 (3.8 percent of $100,000) in addition to other income tax due. Since the traditional IRA distributions increase MAGI over the applicable $250,000 threshold in an amount greater than the couple's net investment income, the effect is that all of the couple's net investment income becomes subject to the investment income tax. If the traditional IRA's had previously been converted to Roth distributions would be required, the couple could take distributions of any amount, and no investment income tax would be due because the couple's MAGI would stand at the $250,000 threshold amount.* IRA's, then no required minimum

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