Final and new proposed regulations for 3.8% Medicare surtax

OVERVIEW

Beginning in 2013, “net investment income” (NII) is subject to an additional 3.8% surtax to the extent your “modified adjusted gross income” exceeds certain thresholds. This surtax was enacted as part of the Health Care and Education Reconciliation Act of 2010, but its effective date was not until 2013. The IRS issued proposed regulations in November of 2012 (the “2012 Proposed Regulations”), and those were summarized in our Tax Alert 2012-07: New Regulations for 3.8% Medicare Surtax Answer Several Questions, Leave Others Unanswered. A year later, in November of 2013, the IRS issued final regulations (the “Final Regulations”) and a new set of proposed regulations (the “2013 Proposed Regulations”). This Tax Alert summarizes the Final Regulations and the 2013 Proposed Regulations, which span over 300 pages. Therefore, this Tax Alert only summarizes the highlights most relevant for U. S. Trust clients and their advisors. We are also updating our two Wealth Strategy Reports on this subject: The 3.8% Medicare Surtax on Investment Income – Individuals and The 3.8% Medicare Surtax on Investment Income – Trusts. If you would like to receive these when they are updated, please let your U.S. Trust representative know.

ALLOWABLE DEDUCTIONS EXPANDED

The surtax is imposed on “net investment income,” which is defined as the excess of certain amounts of investment income over “the deductions . . . properly allocable to such gross income or net gain.” The 2012 Proposed Regulations clarified which deductions were available when calculating NII, but the number of deductions allowed was quite limited. The Final Regulations add many more. If any allowable deduction applies both to NII and income that is not NII, then the deduction must be apportioned between the two. The Final Regulations allow this to be done by “any reasonable method.” If any of these expenses are limited for regular income tax purposes by (i) the 2% floor for “miscellaneous itemized deductions”, or (ii) the so-called “Pease” limitations for certain itemized deductions, those same limitations will apply for purposes of the 3.8% surtax.

Under the Final Regulations, the following are deductible when calculating NII (subject to various limitations and the apportionment referred to above):

1. deductions allocable to gross income from rents and royalties;
2. deductions allocable to gross income from trades or businesses that generate NII (i.e., passive activities or trading in financial instruments);
3. a penalty on early withdrawal of savings;
4. a net operating loss;
(5) investment interest as defined in section\(^1\) 163(d)(3);
(6) investment expenses as defined in section 163(d)(4)(C) (i.e., deductions allowed (other than for interest) which are directly connected with the production of investment income);
(7) state income taxes;
(8) unrecovered basis in an annuity when the annuitant dies with unrecovered basis;
(9) items described in section 691(c) (i.e., deductions in respect of a decedent);
(10) investment expenses described in section 212(3) (i.e., incurred for the determination, collection or refund of a tax):
(11) amortizable bond premium;
(12) in the case of an estate or trust, fiduciary expenses deductible under section 212;
(13) non-capital losses described in section 165 \(^2\); and
(14) excess losses under section 642(h) upon termination of a trust or estate.

WHEN IS A TRUST “PASSIVE”?\(^3\)

One type of income that is included in NII is income from a “passive activity,” which in general is a trade or business in which you do not “materially participate.” The phrase “passive activity” is from the passive activity loss rules, first enacted in 1986. Those passive activity rules apply to trusts, but there have been no trust regulations issued since the statute was first enacted, and so it remains unclear how to determine whether a trust is “passive” with respect to a business.

The new surtax adds at least two new planning concerns for trusts with respect to passive activity income. First, if a trust receives income from a business and is taxed on that income (i.e., the trust does not distribute the income but retains it), will that be NII to the trust, subject to the surtax? If the trust is passive, the answer is yes. In contrast, if the trust materially participates, the answer is no. This is the same issue that has been around, unanswered, since 1986. Second, if the trust distributes that income to a beneficiary, will that be passive activity income, and therefore NII, to the beneficiary?

Although the issue of whether a trust is “passive” has even more importance now, there is no additional guidance whatsoever in the new regulations. This issue continues to remain unaddressed over 27 years after the passive activity loss rules were enacted.

PASSIVE ACTIVITY REGROUPING ONLY FOR INDIVIDUALS, NOT S CORPORATION OR PARTNERSHIP

When determining whether you are engaged in a “passive activity” for regular income tax purposes, how you define “activity” is very important. For example, it is possible that you participate in two separate businesses but in neither one does your participation rise to the level of “material participation.” However, if you were to consider both businesses together to be one “activity,” then your level of involvement might indeed be “material.” For regular tax purposes, there are regulations governing the extent to which you can “group” activities. Generally, once you have grouped activities, you cannot change those groupings.

The 3.8% surtax raises a new consequence for being engaged in a passive activity: passive activity income is NII. Because of that, the Final Regulations allow you to elect to regroup passive activities, once. Such a regrouping

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\(^1\) References are to the Internal Revenue Code (IRC).
\(^2\) Capital losses are allowed when calculating “net gain,” which is its own category of NII. However, excess capital losses cannot offset other types of NII (except to the extent of $3,000).
would apply both for regular tax purposes and surtax purposes. You have to make this election to regroup on the tax return for the first year you are be subject to the surtax, beginning with taxable years beginning after December 31, 2013. You may, however, apply this regrouping rule to tax years beginning after December 31, 2012.

Comments to the 2012 Proposed Regulations requested that in addition to allowing individuals to regroup activities, S corporations and partnerships also be allowed to make entity-level regroupings. This was rejected by the IRS; only individuals (and trusts and estates) can regroup activities under this special rule.

**TREATMENT OF CHARITABLE REMAINDER TRUSTS (CRTs)**

There has been a significant change in the surtax treatment of CRTs.

**The 2012 Proposed Regulations.** The surtax does not apply to a CRT. However, under the 2012 Proposed Regulations, a CRT would have to track the NII that it receives, on a cumulative basis. Amounts distributed to a beneficiary would be deemed to be NII to the extent the CRT has current or accumulated NII that has not yet been distributed; that amount would be NII to the beneficiary. This surtax result would apply regardless of whether the items comprising the CRT’s NII were considered distributed for regular income tax purposes.

**Example illustrating the 2012 Proposed Regulations.** For regular tax purposes, in 2013 a CRT has $50,000 of ordinary income that is not NII (e.g., an IRA distribution). The CRT also has $40,000 of long-term capital gain, which is NII and must be tracked as such by the CRT. The CRT distributes the annual annuity of $50,000 to the beneficiary. For regular tax purposes, this $50,000 is considered to come from the ordinary income, which is not NII. For surtax purposes, however, the CRT has $40,000 of NII (the capital gain), and therefore the distribution to the beneficiary is deemed to “carry out” $40,000 of NII.

**The Final Regulations.** The Final Regulations jettison this approach and more closely follow the current “tier” system that applies to CRT distributions for regular tax purposes. This approach under the Final Regulations is applicable for taxable years of a CRT that begin after December 31, 2012.

Under the already-existing rules of this “tier” system, a CRT’s income is categorized into: (1) ordinary income; (2) capital gain; (3) other income; and (4) principal. Within each of the first three categories, a hierarchy of “classes” of income is created based on the highest federal income tax rate that can be imposed on that “class.” Distributions from the CRT are deemed to “carry out” income based on the so-called “highest-taxed in, first out” (HIFO) system. That is, distributions are considered to come from the highest numbered “category” until it is exhausted, and distributions from within a category are considered to come from the highest-taxed “class” within that category until that class is exhausted. For each class of income, the Final Regulations simply create an additional class: income that is NII. For purposes of classifying income in the tier hierarchy just described, the tax rate for each class of income that is NII is simply increased by 3.8%. With that, the usual rules of the “tier” system apply.

For example, prior to 2013 long-term capital gain would be in the second “tier” (capital gain category) and would have a tax rate of 15% for purposes of placing it in the class hierarchy for that category. Now, under the Final Regulations, long-term capital gain recognized by the CRT prior to 2013 (which is not NII) will have a tax rate of 20% (currently the highest capital gain rate), and long-term capital gain recognized after 2012 (which is NII) will have a tax rate of 23.8%, meaning it would be considered distributed before the pre-2013 gain.
Returning to the previous “Example illustrating the 2012 Proposed Regulations,” using those same facts, the distribution of $50,000 would be treated as coming from category 1 ordinary income both for regular income tax purposes and surtax purpose. This $50,000 distribution would not “carry out” any NII.

Election to use 2012 Proposed Regulations. The 2013 Proposed Regulations provide that a CRT can elect to use the method set out in the 2012 Proposed Regulations (referred to as the “simplified method”). The 2013 Proposed Regulations state that such an election must be made on the CRT’s return for the first year beginning on or after January 1, 2013. This election is irrevocable.

Warning: The Preamble to the 2013 Proposed Regulations states: “If, after consideration of all comments received in response to these proposed regulations, it appears that there is no significant interest among taxpayers in having the option of using the simplified method, the Treasury Department and the IRS may omit this election from the regulations when finalized.” Thus, there appears to be a risk that a CRT irrevocably electing to use the “simplified method” might be in a situation where that method is subsequently taken away. What the result of that would be is unclear.

SPECIAL RULES FOR SALE OF S CORPORATION STOCK OR PARTNERSHIP INTERESTS

In the case of gain on the sale of stock in an S corporation or an interest in a partnership (or an interest in an LLC treated for tax purposes as a partnership), the seller’s gain will constitute NII only to the extent that gain would have been NII if the entity (the S corporation or partnership/LLC) had sold all of its property for fair market value “immediately before” the stock or interest was sold. This is intended to be a pro-taxpayer provision, shielding from the 3.8% surtax net gain attributable to assets used in an active trade or business.

The 2012 Proposed Regulations had set out a rather complicated 4-step process that one must go through in order to get the benefit of this rule. These steps were: (1) pretend there was a cash sale by the entity of all properties; (2) determine the pretend gain/loss for each property; (3) determine how much gain/loss would be allocated to the selling partner/shareholder for regular income tax purposes; (4) determine how much of that gain/loss would be attributable to property held in an active trade or business. After these 4 steps, if there was gain attributable to property held in an active trade or business, that amount of gain would be subtracted from the gain on the sale of the interest in the S corporation, partnership/LLC when calculating NII. If there was loss attributable to property held in an active trade or business, that would be ignored (i.e., all the gain on the sale of the interest would constitute NII).

Based on comments, the Final Regulations withdraw this approach and do not address this issue. The 2013 Proposed Regulations propose an entirely new set of rules for this provision. These new rules are discussed in our Wealth Strategy Report: The 3.8% Medicare Surtax on Investment Income – Individuals

TREATMENT OF GOODWILL

Gain on the sale of assets used in a non-passive business is not subject to the surtax. An important question raised by this provision was whether goodwill was considered a business asset. The 2012 Proposed Regulations answered this question, doing so in the context of addressing the sale of an interest in a non-passive partnership or S corporation. The 2012 Proposed Regulations stated that if such an interest were sold but some of the gain was attributable to goodwill, that gain would not be NII.3 As mentioned in the preceding section, those

3 2012 Prop Reg § 1.1411-7(c)(5)(ii)(B). Also, Section 8(A)(ii) of the Preamble to the 2012 Proposed Regulations: “The proposed regulations provide rules to determine the treatment of gain or loss from goodwill for purposes of section 1411(c)(4). If the entity is engaged in one trade or business, the entire gain or loss on the
regulations addressing the sale of an interest in an S corporation or partnership have been withdrawn and replaced by the 2013 Proposed Regulations, which set forth all new rules that do not address goodwill. It’s not clear how to interpret that development.

“NET UNREALIZED APPRECIATION”
Upon retirement, you have choices as to how the retirement plan balances in your company’s plans will be distributed to you. For a “qualified” plan, a common approach is to take a lump sum distribution of the entire balance and roll it into an IRA. If your qualified retirement plan includes stock in your company, you have an alternative. Rather than having that stock transferred to an IRA, you could instead have it distributed to you to keep "outside" of the IRA. (The other assets could still be transferred to an IRA.) Although normally you would incur income tax on the value of any stock distributed to you from a retirement plan, if you satisfy certain conditions, you would incur current income tax only on the cost of the company stock but not on the stock's built-in appreciation at the time of distribution from the plan (the built-in appreciation is referred to as net unrealized appreciation (NUA)). You would incur tax on the NUA only if you subsequently sell the stock, and then it would be taxed as long-term capital gain regardless of when sold. (However, appreciation accruing after the distribution would be short-term gain until the post-distribution holding period was greater than one year.)

For surtax purposes, the statute expressly states that distributions from the following retirement plans are not NII: (1) qualified pension, profit-sharing, and stock bonus plans; (2) qualified annuity plans; (3) annuities for employees of tax-exempt organizations or public schools; (4) IRAs; (5) Roth IRAs; (6) deferred compensation plans of state and local governments and tax-exempt organizations. The Final Regulations add that “net unrealized appreciation” attributable to employer securities will continue to be considered a distribution from a qualified plan, even upon subsequent disposition. Thus, that gain would not be subject to the surtax. However, appreciation occurring after the distribution of the employer stock would be gain includible in NII when recognized.

RATE SWAPS (NOTIONAL PRINCIPAL CONTRACTS)
Under the 2012 Proposed Regulations, payments under notional principal contracts, such as interest rate swaps and equity swaps, were deemed not to be NII (unless business income from a passive activity). From Section 5(A)(ii)(a) of the Preamble to the 2012 Proposed Regulations:

Gross income from notional principal contracts (within the meaning of §1.446-3(c)) is not included in net investment income under section 1411(c)(1)(A)(i). However, if gross income from notional principal contracts is derived in a trade or business described in proposed §1.1411-5, all of such gross income is included in net investment income under section 1411(c)(1)(A)(ii). In addition, gain on a disposition of a notional principal contract is included in net investment income under either section 1411(c)(1)(A)(ii) or section 1411(c)(1)(A)(iii) (see parts 5.B and 5.C of this preamble).

Based on comments to the 2012 Proposed Regulations, the 2013 Proposed Regulations reverse this and now do indeed include such payments in NII.

Goodwill will be treated as gain or loss from the disposition of property held for use in that trade or business, and no portion of such gain or loss will be treated as attributable property not held for use in the trade or business.”
MARK-TO-MARKET INCOME AND GAINS

There were certain types of investment income not clearly within the types of “net investment income” listed in the surtax statute. The 2012 Proposed Regulations expanded the types of income that constitute NII. Under certain statutory or regulatory provisions, such as IRC section 1256 or 1296, a non-trader may be required to mark assets to market, being taxed as if the assets had been sold. Under the 2012 Proposed Regulations, such gains were deemed to be NII. However, under the Final Regulations, mark-to-market gains under 1296 are addressed but no mention is made of 1256 gains. As a result, it’s less than clear how such gains are treated under the surtax.

$3,000 EXCESS CAPITAL LOSS CAN OFFSET NON-GAIN NII

For regular income tax purposes, excess capital losses can offset ordinary income up to $3,000 annually. However, under the 2012 Proposed Regulations, for surtax purposes, after calculating “net gain,” this $3,000 loss could not offset other NII. For example, such an excess loss could not offset interest and dividends for surtax purposes. The Final Regulations, however, change this treatment and allow excess capital losses to offset non-gain NII, up to $3,000.

INCOME AND LOSSES OF TRADERS COORDINATED

Two of the kinds of income included in NII are (i) gross income derived from a trade or business of trading in financial instruments; and (ii) “net” gain (i.e., capital gains net of capital losses). In addition, when calculating “net gain,” excess losses from that category cannot offset other categories of NII (other than the $3,000 mentioned in the preceding section). As a result, there was a concern that in the case of a trader (someone who trades securities as a profession), there could be a “whipsaw” effect where (i) gains/income would be in the first category just mentioned, but (ii) losses would be in the second category and could not offset those gains/income for surtax purposes. Fortunately, the Final regulations address this and make it clear that a trader’s gains and losses will offset for surtax purposes.

STATE INCOME TAX REFUNDS

One of the deductions allowed in computing NII is state income tax apportioned to NII. (Total state income tax has to be apportioned between (i) NII and (ii) income that is not NII.) The 2012 Proposed Regulations did not address the issue of how to treat a state income tax refund of amounts that, when originally paid, were deducted for surtax purposes. The Final Regulations do address that issue. If state income tax is deducted for surtax purposes, and if there is a later refund of that tax, when calculating your surtax in the year of the refund, your deductions will be reduced by a portion of the refund, under rules set forth in the Final Regulations.

This treatment would apply to any of the surtax deductions listed on the first two pages, if one of those was later recovered. State income tax refunds are a common example of such a recovery.

QUALIFIED SUBCHAPTER S TRUSTS (QSSTs)

A QSST is a trust that qualifies to be an S corporation shareholder. One of the requirements of a QSST is that there be only one income beneficiary. In general, for regular income tax purposes the QSST income beneficiary is treated as the owner with respect to the S corporation stock held by the trust, reporting all the income that “flows through” with respect to the S corporation stock.

- **Exception:** If the trust sells the S corporation stock, for income tax purposes that’s treated as a disposition by the trust, not the beneficiary.
• **Exception to the exception**: For purposes of applying the passive activity loss rules to the QSST beneficiary, a disposition of S corporation stock by the QSST is treated as a disposition by the QSST beneficiary. This is a beneficial rule because it allows any suspended passive activity loss (to the extent not allowed by reason of the QSST beneficiary’s other passive net income in the disposition year) to be considered a loss from a nonpassive activity.

These rules raise an issue under the surtax: If a QSST sells the S corporation stock, for purposes of the 3.8% surtax it matters whether that’s the disposition of an interest in a passive or active business. If it’s the disposition of an interest in an active business, that allows gain on that disposition to be excluded from NII. (This is discussed above in the section: *Special Rules for Sale of S Corporation Stock or Partnership Interests*. ) If it’s the disposition of an interest in a passive business, that special rule would not apply. In making that determination, is it the QSST beneficiary’s participation that matters, or is it the trust’s participation that matters?

The 2012 Proposed Regulations did not address this issue but invited comment on it. The Final Regulations also do not address this issue. The 2013 Proposed Regulations propose that it be the trust’s participation that determines this issue, not the QSST beneficiary’s:

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Unfortunately, as discussed previously, there are no regulations addressing how a trust determines whether it is a passive participant in a business. From that perspective, it doesn’t provide a useful answer to state that the disposition of stock by a QSST does or does not qualify for special treatment depending on whether the trust itself is passive.

**EFFECTIVE DATES**

The surtax is imposed on individuals, trusts and estates and is effective for tax years beginning after December 31, 2012. The Final Regulations are effective for taxable years beginning after December 31, 2013. However, you can choose to have the Final Regulations apply for 2013. The provisions governing Charitable Remainder Trusts, however, are required to be applied for tax years beginning after December 31, 2012.

Similarly, the 2013 Proposed Regulations are proposed to be effective for taxable years beginning after December 31, 2013. However, the provisions governing Charitable Remainder Trusts (the election to use the “simplified method, discussed below) are proposed to be effective for tax years beginning after December 31, 2012.

— National Wealth Planning Strategies Group