Tax Resolution for 2014 – Be Proactive to Minimize Your Exposure to the New Net Investment Income Tax

Written By **Lee C. Hodge** (lch@wardandsmith.com)
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The net investment income tax is a 3.8% federal tax that applies to certain taxpayers with passive income. It is important that you understand how this new tax works so that you can take steps to minimize your exposure to it.

Overview

The federal net investment income tax ("NII Tax") is a new 3.8% tax that was implemented as part of the Patient Protection and Affordable Care Act (a/k/a "Obamacare") and became effective on January 1, 2013. Despite the name "Unearned Income Medicare Contribution" given the NII Tax in Section 1411 of the Internal Revenue Code, the taxes collected pursuant to the NII Tax will go directly into the general tax fund to support the operations of the federal government.

The NII Tax is imposed on the lower of:

- A taxpayer's modified adjusted gross income in excess of a set threshold ($200,000 for single filers and $250,000 for joint filers); or,
- The taxpayer's "net investment income."

Net investment income is income derived from one of the following three categories:

- Traditional portfolio income such as rents, royalties, interest, and dividends;
- Income received from businesses in which the taxpayer does not materially participate; and,
- Capital gains realized in connection with the disposition of either:
  - Traditional portfolio investments, or,
  - A passive asset.

Fortunately, there are certain types of income that are not considered to be net investment income, including the following:

- Earned income (i.e., wages and self-employment income);
- Distributions from an IRA or a qualified retirement plan; and,
- Income from a business in which the taxpayer materially participates.

For proof of how complex the NII Tax is, you only need to look at the 19 pages of instructions recently released by the IRS to explain how tax return preparers will use the one-page NII Tax reporting form. Let's delve into the NII Tax so that you can better understand its application.

First Question – Do I Have Enough Modified Adjusted Gross Income To Be Subject To The NII Tax?

As described above, the NII Tax is imposed on the lower of:

- A taxpayer's modified adjusted gross income in excess of a set threshold ($200,000 for single filers and $250,000 for joint filers); or,
- The taxpayer's net investment income.

Consequently, if a single filer does not have modified adjusted gross income of more than $200,000, then the taxpayer will not be subject to the NII Tax during the subject tax year, regardless of how much net investment income the taxpayer has. This same scenario applies to a taxpayer who files a joint tax return with his/her spouse if the spouses collectively have modified adjusted gross income of less than $250,000.

However, if a couple who files a joint return reported salary/wage income of $225,000 and net investment income of $30,000 during the subject tax year, then the couple would owe the NII Tax on $5,000, which is the lower of the couple's modified adjusted gross income in excess of the applicable threshold ($255,000 - $250,000 = $5,000) and the couple's net investment income ($30,000).

I Understand Rents, Dividends, And Interest Income, But What Is This Business About Material Participation?

The material participation rules are complex rules that determine whether a particular business activity is a passive activity or a non-passive activity. The purpose of the material participation rules is to prohibit taxpayers from entering into passive "tax shelter" transactions and using the losses from the "tax shelter" transactions to offset their non-passive income. Consequently, if an activity is a passive activity, then, among other things, a tax loss generated by the activity generally can only be used to offset income generated by other passive activities, which means that a taxpayer cannot use a passive loss to offset non-passive income such as wages. With respect to the NII Tax, if an activity is a passive activity, then net income generated by the activity generally will be "net investment income" that may be subject to the NII Tax. For pass-through entities such as Subchapter S corporations and limited liability companies, the material participation rules are applied at the individual (i.e., shareholder or member) level. Let's dive into the material participation rules to learn more!

You will be considered to materially participate in an activity if you satisfy any one of the following seven tests:

- You participate in the activity for more than 500 hours during the subject tax year;
- Your participation in the activity constitutes substantially all of the participation in the activity during the subject tax year;
- You participate in the activity for at least 100 hours and no one participates more than you during the subject tax year;
- The activity is a "significant participation activity" (i.e., any activity in which you participated for at least 100 hours during the subject tax year in which you are determined not to have materially participated) and you participated in significant participation activities for a total of at least 500 hours during the subject tax year;
- You materially participated in the activity for any five of the last ten tax years;
- The activity is a "personal service activity" (i.e., healthcare, law, accounting, engineering, and other specified businesses) and you materially participated in the subject activity during any three preceding (whether or not consecutive) tax years; and,
- Based on all of the facts and circumstances, you participated in the activity on a regular, continuous,

and substantial basis during the subject tax year.

When determining how many hours you participated in an activity, you cannot count investor-type hours such as time spent reviewing financial statements or monitoring finances in a non-managerial capacity, unless you are directly involved in the day-to-day management of the activity. Additionally, travel time generally will not be counted, unless the travel is integral to the activity.

Grouping Activities – Aggregating Your Hours To Meet The Material Participation Test

There are special rules that allow you to group certain activities together and then aggregate your participation in such activities to make it easier to meet the annual hour requirements of the material participation rules and thereby make all of the grouped activities non-passive activities. With respect to the NII Tax, if you meet one of the material participation tests with respect to such grouped activities, then all income generated by the grouped activities will be non-passive and, therefore, will not be subject to the NII Tax.

You generally must obtain consent from the IRS to re-group activities. However, you have a one-time opportunity to re-group your activities without any IRS consent when you file your 2013 federal tax return. If you have multiple passive activities that currently are not grouped together, you should consult with your tax attorney and accountant to discuss the pros and cons of re-grouping your activities in a manner that will enable you to potentially transform a group of activities into non-passive activities.

Self-Rental Income Is Exempt From The NII Tax

Many businesses that own the real estate on which the business operations are conducted (as opposed to leasing such real estate from a third party owner) hold the real estate in one entity and operate the business in another entity, with the operating entity leasing the real estate from the real estate holding entity. The rent received by the real estate holding entity is considered self-rental income for tax purposes. Tax practitioners were very concerned that income received by the real estate holding entities would be subject to the NII Tax if, as is often the case, the subject lease was a "triple net lease" where the lessee/operating entity pays all of the "landlord's" expenses such as property taxes, insurance, and repair and maintenance fees so that the net income to the "landlord" is the same as the rent payments. However, the IRS recently released regulations providing that self-rental income is exempt from the NII Tax, which alleviated these concerns.

Application Of The NII Tax To Estates And Trusts

There are special rules regarding the application of the NII Tax to estates and trusts, but these rules are beyond the scope of this article. You should consult with your accountant and tax attorney if you have questions regarding the application of the NII Tax to your estate or a trust you established.

Conclusion

The NII Tax is a complex tax that you should not ignore. If you have not consulted with your tax attorney and accountant to discuss how you can structure your business and investment holdings to minimize or eliminate your exposure to the NII Tax, then you should do so quickly. You need to have this conversation before you file your 2013 tax return so that you can determine whether you should re-group your business and investment activities using the IRS's one-time "free pass" for re-grouping activities.

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Lee C. Hodge.

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