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WHAT CONSTITUTES "NET INVESTMENT INCOME" FOR PURPOSES OF THE 3.8% MEDICARE NET INVESTMENT INCOME SURTAX

Effective January 1, 2013, pursuant to the Patient Protection and Affordable Care Act, 26 U.S.C. § 1411 imposes a 3.8% Net Investment Income Tax on individuals, estates and trusts which have "Net Investment Income" and modified adjusted gross income above specified statutory threshold amounts. For individuals, the tax is imposed on the lesser of: (A) the Net Investment Income for the taxable year, or (B) the excess of modified adjusted gross income for the taxable year over the threshold amount ($250,000 for married individuals filing jointly; $125,000 for married individuals filing separately; $200,000 for single individuals). For estates and trusts which are subject to the tax, the tax is imposed on the lesser of: (A) the undistributed Net Investment Income for the taxable year, or (B) the adjusted gross income for the taxable year over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year.

For purposes of the tax, "Net Investment Income" is defined as the sum of the following, less any applicable deductions:

- Gross income from interest, dividends, annuities, royalties and rents, which amounts were derived from a passive trade or business activity (as defined by 26 U.S.C. § 469), or from a trade or business involved in trading in financial instruments or commodities (as defined in 26 U.S.C. § 475(e)(2))
- Other gross income derived from a passive trade or business activity, or from a trade or business involved in trading in financial instruments or commodities
- Net gain, to the extent it is taken into account in computing taxable income, which is attributable to the disposition of property from a passive trade or business activity, or from a trade or business involved in trading in financial instruments or commodities

Applicable deductions may include expenses related to investment interest, advisory and brokerage fees, rental and royalty income, and state and local income taxes which are allocable to items included in Net Investment Income.

Net Investment Income specifically does not include such items as wages, unemployment compensation, operating income from non-passive business activities, social security

benefits, alimony, tax exempt interest, self-employment income, Alaska Permanent Fund Dividends, and distributions from certain qualified retirement plans. However, these items may be subject to the .9% Additional Medicare Tax.

The following paragraphs highlight a few of the rules specific to particular types of income which may or may not be subject to the tax. The information provided herein is not intended to address all sources of income subject to the tax, or provide an exhaustive summary of the applicable rules.

S-Corporations. Generally, an interest in a pass-through entity such as an S Corporation is not property held in a trade or business, so that any gain or loss from the sale of such interest would be Net Investment Income. However, the IRS has limited the amount of gain or loss from the disposition from an interest in an S Corporation to the net gain or loss that would result if the S Corporation sold all of its assets at fair market value immediately before the disposition of the interest.

Working Capital. Any income, gain or loss attributable to capital set aside for the future needs of a trade or business is Net Investment Income.

Child's Interest. Any amount included on a parent's Form 1040 as a result of filing Form 8814 for Parent's Election to Report Child's Interest and Dividends is included in calculating Net Investment Income, but does not include any amount excluded on Form 1040 due to threshold requirements.

Pension and Deferred Compensation Distributions. While Net Investment Income does not include distributions from certain qualified employee benefit plans, such distributions are included in determining the threshold amounts if they are included in the taxpayer's gross income.

The rules regarding the Net Investment Income Tax are complex and continue to evolve as final regulations are determined. In making a determination of how you may be impacted by the tax, it is important to contact a professional who may advise you as to the application of specific rules to your particular situation.

If you have any questions regarding this article, please contact Attorney Megan Harried at O'Neil Cannon at 414-276-5000.