

Additional Affordable Care Taxes Imposed on Individuals

- A. Five Individual Affordable Care Act Taxes Imposed on Individuals
 - 1. Additional Medicare Tax on Wages
 - 2. Net Investment Income Tax
 - 3. Increased Threshold for Medical Expenses
 - 4. Limit on Health Care Flexible Spending Accounts
 - 5. Indoor Tanning Salon Tax
- B. Additional Medicare Tax on Earned Income
 - 1. 0.9% Additional Medicare Tax applies to wages and net self-employment income for tax years beginning in 2013.
 - 2. Applies to wages exceeding \$200,000 for single, head-of-household, or surviving spouse; \$250,000 for married filing jointly; \$125,000 for married filing separately.
 - a. Applicable thresholds are not adjusted for inflation.
 - 3. Applies to the employee's share of wages.
 - a. Does not apply to the employer's employment taxes.
 - 4. There are no special rules for nonresident aliens and U.S. citizens living abroad for purposes of the Additional Medicare Tax. Wages, other compensation, and self-employment income that are subject to Medicare tax will also be subject to the Additional Medicare Tax if in excess of the applicable threshold.
 - 5. The Additional Medicare Tax on wages will be calculated on Form 8959, Additional Medicare Tax, and shown as "Other Taxes" on page 2 of Form 1040.
 - 6. Wages are broken into 3 Tiers for 2014
 - a. Tier 1 -- From \$0 to \$117,000; 7.65% x employee's wages.
 - b. Tier 2 -- From \$117,000 to \$200,000/\$250,000; 1.45% x employee's wages.
 - c. Tier 3 -- Above \$200,000/\$250,000 of wages; 2.35% x employee's wages.
 - 7. The threshold amount for the Additional Medicare Tax applies separately to the FICA and the Railroad Retirement Tax Act.
 - a. Therefore, the amount of RRTA compensation taken into account in determining the Additional Medicare Tax under the RRTA will not reduce the threshold amounts under Section 1401(b)(2)(A) for determining the Additional Medicare Tax under the SECA.

8. 6.2% – Social Security Tax - Old Age, Survivors, and Disability Insurance (OASDI)
1.45% – Medicare Tax - Hospital Insurance (HI)
0.9% – Additional Medicare Tax - Additional Medicare Tax
9. The housing exclusion for clergy applies to the income tax but not for self-employment tax purposes. Therefore, the housing exclusion amount will be subject to the potential Additional Medicare Tax.
10. Income subject to the Medicare Tax is not also subject to the Net Investment Income Tax.
11. The Additional Medicare Tax on earned income is part of the employer's overall withholding.
 - a. The employee reconciles the final total of any Additional Medicare Tax when they file their Form 1040 for the tax year.
12. Employers are required to apply the additional withholding at \$200,000 of wages, including taxable fringe benefits, bonuses, tips, commissions, and other supplemental payments, the total amount of taxable Box 5.
 - a. Does not matter what filing status is shown on Form W-4.
 - b. The employer applies the \$200,000 threshold to each spouse in applying the Additional Medicare Tax. In effect the employer disregards the amount of wages received by the other spouse in computing the Additional Medicare Tax for each spouse.
13. Example 1. One spouse received \$210,000 of wages, while the other spouse earned \$35,000 of either W-2 wages or net self-employment income.

The employer of the first spouse is required to withhold an additional 0.9% Additional Medicare Tax on the last \$10,000 of taxable wages (i.e., \$90) even though the couple will not owe the 0.9% Additional Medicare Tax when they file their Form 1040.

They will receive a tax credit against any other type of tax that may be owed.
14. If an employer fails to withhold the 0.9% Additional Medicare Tax, and the tax is subsequently paid by the employee, the IRS will not collect the tax from the employer.
 - a. The employer will remain subject to any applicable penalties on additions to tax for failure to withhold the 0.9% Additional Medicare tax as required. [Sec. 3102(f)(3)]
15. The employee is personally responsible if the employer fails to withhold the 0.9% additional Medicare tax. [Sec. 3102(f)(2)]
 - a. Hopefully this means that the employee will be liable only if the employer fails to withhold the tax, not if the employer withholds but does not remit the tax.
16. Example 2. A husband and wife who earned Box 5 Medicare wages of \$175,000 and \$125,000, respectively, would not have any additional withholding tax taken out by the employers.

Nevertheless, they would still owe \$450 $((\$175,000 + \$125,000 - \$250,000 \text{ threshold}) \times 0.9\%)$ in Additional Medicare Tax when they file their Form 1040.

17. Maximizing any contributions to a qualified retirement plan such as a 401(k) or a 403(b) would not impact the Additional Medicare Tax calculation even though it does reduce Box 1 "Wages, tips, & other compensation" for Federal income tax withholding purposes.
 - a. Box 5 is used for determining the Additional Medicare Tax and withholding.
18. The self-employed individual will coordinate the 0.9% Additional Medicare Tax with their self-employment tax as follows:
 - a. Tier 1 -- From \$0 to \$117,000; 15.3% x net self-employment income.
 - b. Tier 2 -- From \$117,000 to \$200,000/\$250,000; 2.9% x net self-employment income.
 - c. Tier 3 -- Above \$200,000/\$250,000; 3.8% x net self-employment income.
19. The self-employed individual does not receive an income tax deduction for one-half of the 0.9% Additional Medicare Tax on earned income.
 - a. Any deduction comes from the employer's portion of employment taxes.
20. Example 3. A husband and wife each have "Box 5 Medicare wages" of \$150,000 listed on their respective W-2s. The combined \$300,000 "earned income" will be shown on Form 8959 for calculating the 0.9% Additional Medicare Tax. The couple will owe a 0.9% Additional Medicare Tax of \$450 ($(\$300,000 - \$250,000 \text{ threshold}) \times 0.9\%$) and that amount will be included as "Other Taxes" on page 2 of Form 1040.
21. Example 4. A husband has \$150,000 of "Box 5 Medicare wages" listed on his W-2. His wife has a K-1 from her law firm listing Box 14 self-employment income of \$162,426 (\$150,000 net self-employment income). The couple will owe \$450 of Additional Medicare Tax on their collective earned income.
 - a. Any deduction for a contribution to a qualified retirement plan would come after the calculation of her self-employment tax on Schedule SE, as well as the 0.9% Additional Medicare Tax calculation.
22. Example 5. A husband has \$150,000 of "Box 5 Medicare wages" listed on his W-2. His wife has a K-1 from her law firm listing Box 14 net self-employment income of \$150,000. The wife also has a \$50,000 loss from the start-up of a new Schedule C business. Since the self-employment income of the wife would now be only \$100,000, when it is added to the \$150,000 in W-2 wages of the husband, the couple is not above the "applicable threshold" of \$250,000 for married filing jointly. Therefore, no Additional Medicare Tax on their collective earned income would be due.
23. Example 6. A husband and wife each have "Box 5 Medicare wages" of \$150,000 listed on their respective W-2s. The wife also has a \$50,000 loss from the start-up of a new Schedule C business. The couple would still owe \$450 of Additional Medicare Tax.
 - a. The self-employment loss is not permitted to offset W-2 wages.
24. Example 7. The husband has \$190,000 in wages subject to Medicare tax and the wife has \$150,000 in compensation subject to RRTA taxes. The husband and wife do not combine their wages and RRTA compensation to determine whether they are in excess of the \$250,000 threshold for a joint return. The husband and wife are not liable to pay Additional Medicare Tax because the husband's wages are not in excess of the \$250,000 threshold and the wife's RRTA compensation is not in excess of the \$250,000 threshold.

25. Individuals with wages subject to FICA tax and self-employment income subject to the self-employment tax calculate their liabilities for the Additional Medicare Tax in three steps:

Step 1: Calculate the Additional Medicare Tax on any wages in excess of the applicable threshold for the filing status, without regard to whether any tax was withheld.

Step 2: Reduce the applicable threshold for the filing status by the total amount of Medicare wages received, but not below zero.

Step 3: Calculate the Additional Medicare Tax on any self-employment income in excess of the reduced threshold.

26. Example 8. C, a single filer, has \$130,000 in wages and \$145,000 in net self-employment income.
1. C's wages are not in excess of the \$200,000 threshold for single filers, so C is not liable for the Additional Medicare Tax on these wages.
 2. Before calculating the Additional Medicare Tax on net self-employment income, the \$200,000 threshold for single filers is reduced by C's \$130,000 in wages, resulting in a reduced net self-employment income threshold of \$70,000.
 3. C is liable to pay the Additional Medicare Tax on \$75,000 of self-employment income; \$145,000 in net self-employment income minus the reduced threshold of \$70,000.
27. Additional withholding or estimated taxes may be needed to avoid an underpayment penalty caused by the Additional Medicare Tax on earned income.
28. Tax Planning Tips:
- a. Use S corporations to avoid wages and self-employment income.

C. Net Investment Income Tax

1. Beginning in 2013, a 3.8% "Net Investment Income Tax" is imposed on individuals and estates and trusts. [Sec. 1411]
 - a. Social Security taxes have traditionally applied only to wages and earned income, the Affordable Care Act imposes a Medicare Surtax on the net investment income of higher income individuals.
 - b. The Net Investment Income Tax is not deductible in computing other taxes.

2. For individuals, the tax is imposed on the lesser of:
 - a. An individual's "net investment income" for the tax year, or
 - b. Any excess of "modified adjusted gross income" (MAGI) for the tax year over a threshold amount. [Sec.1411(a)(1)]
 - 1) The "threshold amount is \$200,000 for single taxpayers and heads-of-households; \$250,000 for married filing jointly and surviving spouses; \$125,000 for married filing separately. (Sec. 1411(b))
 - 2) MAGI is an individual's adjusted gross income for the tax year increased by otherwise excludable foreign earned income or foreign housing costs under Sec. 911 and reduced by any deduction, exclusion, or credits properly allocable to or chargeable against such foreign earned income. [Sec. 1411(d)]
3. Example 9. Elmer, a single individual, earns \$190,000 in wages and/or net self-employment income and also have \$40,000 of "net investment income" for the year. Assuming a \$230,000 MAGI, he will have to pay a 3.8% Net Investment Income Tax on the lesser of his (1) \$40,000 of net investment income, or (2) \$30,000 (\$230,000 MAGI - \$200,000 threshold). Elmer will pay a \$1,140 (\$30,000 x 3.8%) Net Investment Income Tax for the year.
4. Example 10. An unmarried taxpayer received no wages or self-employment income, but lives strictly off of her \$1 million in "net investment income" from a stock and bond portfolio. Assuming a \$1 million MAGI, she will have to pay a 3.8% Net Investment Income Tax on the lesser of her (1) \$1 million net investment income or (2) \$800,000 (\$1 million - \$200,000 threshold). As a result, she will pay a \$30,400 (\$800,000 x 3.8%) Net Investment Income Tax for the year.
5. The Net Investment Income Tax does not apply to a non-resident alien or to a trust "all the unexpired interests in which are devoted to charitable purposes."
 - a. The tax does not apply to a trust that is exempt under Sec. 501 or a charitable remainder trust exempt from tax under Sec. 664.
6. U.S. Territories
 - a. Three of the five U.S. territories (Guam, the Northern Mariana Island, and the United States Virgin Islands) have a mirror code. Therefore, the net investment income tax does not apply to bona fide residents of mirror code jurisdictions because they will not have an income tax liability to the United States.
 - b. The net investment income tax is applicable to bona fide residents on non-mirror code jurisdictions (American Samoa and Puerto Rico) if they have U.S. reportable income that gives rise to both net investment income and modified adjusted gross income exceeding the threshold amount.
 - 1) However, the net investment income tax does not apply if such bona fide resident is a nonresident alien individual with respect to the United States.

7. One Spouse Non-Resident Alien
 - a. The Net Investment Income Tax applies only to the US citizen or resident. The proposed regulations provide that if one spouse is a nonresident alien the spouses are to determine their Net Investment Income and modified adjusted gross income separately and the tax would apply for the US citizen or resident only.
 - b. For the Net Investment Income Tax, the US citizen will be treated as married filing separately and thus subject to the \$125,000 threshold.
 - c. However, the couple can choose to use their worldwide income and include the Net Investment Income of the nonresident alien. They would then use the \$250,000 threshold.

8. "Net investment income" is defined as: [Sec. 1411(c)(1) and (c)(2)]
 - a. Gross income from interest, dividends, annuities, royalties, and rents (other than such income derived in the ordinary course of a trade or business to which the tax does not apply); [Sec. 1411(c)(1)(A)(I)]
 - 1) Substitute interest and dividends are included in the calculation of net investment income.
 - b. Other gross income from any passive trade or business; or [Sec. 1411(c)(1)(A)(ii)]
 - c. Net gain included in computing taxable income that is attributable to the disposition of property other than property held in any trade or business that is not a "passive trade or business." [Sec. 1411(c)(1)(A)(iii)]

9. Refinements
 - a. An employee is treated as engaged in the trade or business of being an employee. Therefore, amounts paid by an employer to an employee that are treated as wages for purposes of Section 3401 are not net investment income.
 - b. "Income derived in the ordinary course of a trade or business" does not include any trade or business that either is a passive activity of the taxpayer, or involves trading in financial instruments and commodities. [Sec. 1411(c)(2)]
 - 1) The passive activity and trading in financial instruments and commodities are defined as "passive business investment income" for purposes of the 3.8% Medicare tax.
 - 2) Financial Instruments
 - Equity interest such as stock
 - Proof of indebtedness
 - Options
 - Notional principal contracts
 - Other derivatives
 - Other evidence of an interest in one of the foregoing items
 - c. A passive investor's share of Form 1065 or Form 1120S from Box 1 on Schedule K-1 would be "other gross income from any passive trade or business."

- d. A Sec. 1231 gain reported on a K-1 from the sale of assets used in a trade or business which the taxpayer "materially participates" would not be treated as "net investment income" subject to the 3.8% Net Investment Income Tax.
 - 1) However, it would be "net investment income" to a passive investor.
- e. "Net investment income" includes any income, gain, or loss that is attributable to an investment of working capital. Income or gain from investment in working capital is treated as not derived in the ordinary course of a trade or business. [Sec. 1411(c)(3)]
 - 1) Example 11. A business puts some of its excess working capital into an income-producing investment such as a certificate of deposit or interest-bearing account, or stocks that pay dividends or result in capital gains or losses when sold. The earnings would be classified as net investment income.

10. Exceptions to "Net Investment Income"

- a. Net investment income does not include:
 - 1) Any distribution from qualified employee benefit plan or retirement arrangements; [Sec. 1411(c)(5)]
 - 2) Any distributions from a regular IRA or Roth IRA; [Sec. 1411(c)(5)]
 - 3) Social security benefits;
 - 4) Gambling winnings;
 - 5) Alimony;
 - 6) Cancellation of debt income;
 - 7) Any item taken into account in determining self-employment income for the tax year on which an individual pays self-employment tax under Sec. 1401(b); [Sec. 1411(c)(6)]
 - a) Example 12. Donna's share of a partnership income for the year is \$30,000. She is not materially participating. In most cases, the \$30,000 would be subject to self-employment tax. When the passive activity income is subject to self-employment tax, the passive activity income is not subject to the Net Investment Income Tax.
 - 8) Income otherwise exempt from tax.
- b. The funds used to make contributions to the various types of retirement accounts have already been subject to employment and Medicare taxes.
- c. Pension income, social security benefits, and IRA distributions are factored into one's AGI which in turn, impacts the determination of whether the applicable \$200,000/\$250,000 MAGI threshold has been exceeded.

11. Gross income for purposes of the 3.8% Net Investment Income Tax on "unearned income" does not include items such as interest on tax-exempt bonds, veterans' benefits, and the excluded gain from the sale of a principal residence.
 - a. These items are otherwise excluded from gross income.
 - 1) Flow-Through to S Corporation Owners Who Materially Participate
 - b. The K-1 profits reported in Box 1 of a materially participating shareholder are not considered "unearned income" (net investment income) for purposes of the 3.8% Medicare tax.
 - c. The K-1 profits reported in Box 1 are not considered "earned income" (wages or self-employment income) for purposes of the 0.9% Medicare tax.
 - 1) The IRS could reclassify distributions as compensation.
12. Example 13. John is the owner of a retail business that rents equipment and machinery. He also materially participates in that business. Regardless of whether the business is operated as an S corporation, LLC/partnership, or a sole proprietorship, any net income or loss therefrom would not be considered for purposes of the 3.8% Net Investment Income Tax calculation.
 - a. A Schedule C sole proprietor or the K-1 recipient of "Box 1- Trades or Business Income" from an LLC/partnership would still have the potential for the 0.9% Medicare tax on earned income.
13. Self-Charged Interest
 - a. The final regulations allow a passthrough owner to exclude self-charged interest for an active participant in the passthrough trade or business, to the extent equal to the individual's allocable share of the passthrough entity's deduction.
 - b. Example 14. Malcolm, is a 40% owner and active participant in passthrough entity Alpha. Malcolm loans Alpha \$200,000 at 5%. Malcolm's \$10,000 in interest income consists of only \$6,000 in investment income since Malcolm's \$4,000 allocable share of Alpha's interest expense may be excluded.
 - c. Self-Charged Interest Proposed Regs. If a taxpayer has gross income from rents from an activity described in Sec. 1.469-2(f)(6) (self-rental) that is not derived in the ordinary course of a trade or business, the gross income from rents will be subject to the Net Investment Income Tax.
14. Self-Rental
 - a. The owners of self-rental properties should not have that rent considered as separate from their overall business activity and subject to the Net Investment Income Tax simply because properties are held in a separate LLC to avoid tort liability. [Reg. 1.469-4(d)(1)]
 - b. Example 15. John leases a building to his retail business. This is a self-rental situation and self-rentals are not classified as passive income. The gross rental income will be deemed to be derived in the ordinary course of a trade or business and, therefore, exempt from the Net Investment Income Tax. Gain or loss from the property will also be treated as gain or loss from the disposition of property held in a nonpassive trade or business.

15. Real Estate Professionals Who Materially Participate in Rental Activities
- a. If a taxpayer is a "real estate professional" and they also "materially participate" in their rental activities, then Sec. 469 passive loss rules do not apply.
 - b. Any rental income or loss derived from such rental activities will not factor into the taxpayer's calculation of the 3.8% Net Investment Income Tax if they meet the definition of trades or business for Section 162.
 - 1) If the taxpayer's activity is not a section 162 trade or business, gross income from rents from the activity will be subject to the net investment income tax.
 - c. Determining whether rental income or gain is "derived in the ordinary course of a trade or business" is a key element in determining whether rental income is subject to the net investment income tax.
 - d. Any rental income or loss derived from such rental activities will not factor into the taxpayer's calculation of the 3.8% Net Investment Income Tax if they meet the definition of trades or business for Section 162.
16. The most established definition of trade or business is found under section 162(a), which permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business.
- a. A taxpayer who qualifies as a real estate professional is not necessarily engaged in a trade or business (within the meaning of section 162) with respect to the rental real estate activities.
 - b. In general, in order for a rental activity to rise to the level of a trade or business, your involvement in the activity must be regular, continuous, and substantial.
 - c. Direct case law or inferred guidance on the issue of what constitutes a trade or business within the context of rental real estate of net investment income tax purposes is vague at best. IRS Field Service Advice 200120036, in connection with an earned income credit issue, noted that, "Where it is clear from the facts that real estate is devoted to rental purposes, the courts have repeatedly held that such use constitutes use of property in a trade or business, regardless of whether or not it is the only property so used."
 - d. In contrast, Example 1 of Prop. Reg. 1.1411-5(b)(2) Ex 1 seems to imply that a rental activity of a single commercial building cannot involve the conduct of a trade or business under Sec. 162.
 - e. If you own commercial properties, each with 20 tenants, each property likely rises to the level of a trade or business due to the efforts required to oversee such a sophisticated operation. On the other hand, if you merely purchase a single family home and rent it out, collecting a check once a month, the activity may very well not rise to the level of a trade or business.
 - f. When the rental activities are owned through a separate LLC, the proposed regulations require that the determination of whether an activity rises to the level of a trade or business must be done at the entity level.

- g. Safe harbor: If a taxpayer qualifies as a real estate professional and also spends more than 500 hours participating in either a separate or grouped rental activity, the IRS will treat those rental activities as trades or businesses. [Reg. 1.1411-4(g)(7)(I)]
- h. Example 16. John is a "real estate professional" for purposes of the passive loss rules. He also "materially participates" in the rental activities that he owns. The Net Investment Income Tax would not apply to the rental activities if his "rental activities" are treated as "trades or business" under Sec. 162. The income would not be subject to any self-employment tax under Sec. 1402.

Under the safe harbor John participates over 500 hours. As a result any net rental income or loss would be not be part of his 3.8% Net Investment Income Tax calculation.

- i. Example 17. Bob owns and manages the rental of 10 commercial properties and also has a 50% interest in 4 single-family homes in which the activities generally are not considered a trade or business under existing standards. If Bob elects to combine rental activities and spends more than 500 hours on the combined 14 properties, all the properties will be considered to rise to the level of a trade or business. None of the rental income will be considered Net Investment Income.
17. The passive loss regs provide that if rents are paid to the taxpayer and come from a business tenant in which they materially participate, such rental income is recharacterized as "nonpassive." However, if there is a rental loss in any given year, then such loss is treated as passive under these recharacterization rules.
 18. Historically, the common strategy for grouping was to maximize passive activity income in order to absorb passive activity losses.
 - a. However, the Net Investment Income Tax takes square aim at passive activity income, so taxpayers may want to re-think their groupings.
 - b. If you had passive losses from other, non-rental sources, continuing to treat the rental income as passive permitted you to offset the non-rental passive losses against the rental income. To the contrary, if you had reported the rental income as nonpassive as a qualifying real estate professional, the passive non-rental losses would have been disallowed because there was no net passive income against which the losses could be offset.
 19. Proposed regulations under Section 469 allow taxpayers to regroup their activities for tax purposes one time after 2012, in the year in which the taxpayer meets the applicable income threshold under Sec. 1411 and has Net Investment Income.
 20. Investment Income Expenses
 - a. For purposes of the Net Investment Income Tax the definition allows the reduction for any otherwise allowable deductions "properly allocable to such income or gain."
 - 1) Deductions under Sec. 62 related to gross income
 - 2) Itemized deductions under Sec. 63
 - 3) Loss deductions under Sec. 165
 - 4) There are special rules for Controlled Foreign Corporations and PFICs

- b. The carryover deductions that are allowed for that taxable year in determining taxable income are also allowed for determination of net investment income, whether or not the taxable year from which the deduction is carried precedes 2013.
 - 1) These carryover deductions include: the limitation of investment interest, at-risk limitations, passive activity loss limitations, partner loss limitations, capital loss carryover limitations, and S corporation shareholder loss limitations.

c. Capital Losses

- 1) Allowable net capital loss deductions (up to \$3,000) are allowed to offset other investment income for purposes of determining net gain for Net Investment Income Tax purposes.
- 2) Noncapital gains include gains treated as ordinary income such as Section 1250 depreciation recapture and Section 751 gains from partnership "hot assets."
- 3) Under the proposed Regs., net capital loss deductions are not allowed to offset other types of investment income that are potentially subject to the net investment income tax, such as dividends and interest. [Prop. Reg. 1.1411-4(d)(2)]
 - a) Any capital loss carried over for regular tax purposes is allowed to offset future gains.
- 4) For net investment income tax purposes, net gains from property dispositions is reduced, but not below zero, by losses that are deductible under Section 165, which covers casualty, theft, and abandonment losses and other losses from worthlessness. [Prop. Reg. 1.1411-4(d)(3)(I)]
- 5) Example 18. In 2014, George, a high-income unmarried individual, has a \$30,000 capital loss from selling A Corporation stock. In 2014, George also has \$5,000 of dividends and interest. George can deduct \$3,000 of his 2014 net capital loss against other income for regular income tax purposes, with the remaining \$27,00 resulting in a capital loss carryover to 2015.

George can reduce his dividend and interest income by his allowable \$3,000 net capital loss deduction. Therefore, in 2014, George has \$2,000 of net investment income for net investment income tax purposes.

In 2015, George has a \$30,000 capital gain from selling B Corporation Stock. He also has \$6,000 of dividend and interest income. For regular federal income tax purposes, George offsets the \$30,000 gain with the \$27,000 capital loss carryover from 2014. For net investment income tax purposes, he is allowed to do the same thing. Therefore, in 2015, George has \$3,000 of net gain for net investment income tax purposes. His net investment income is \$9,000; \$3,000 of net gain plus \$6,000 of dividends and interest.

- 6) Example 19. Using the same facts as in Example 18, except for 2014, George has a \$20,000 Section 1250 ordinary gain from selling a rental property. In determining his 2014 net gain for net investment income tax purposes, George can use his \$3,000 net capital loss deduction to offset part of the Section 1250 ordinary income gain. Therefore, in 2014, George has \$22,000 of net investment income; \$17,000 of net gain from selling the rental property plus \$5,000 of interest and dividends.

His result in 2015 are the same as in Example 18.

- 7) Example 20. Using the same facts as in Example 18, except for 2014, George has a \$35,000 personal casualty loss deduction because his expensive boat sank in a hurricane. In determining his 2014 net gain for net investment income tax purposes, George can use his \$3,000 net capital loss deduction to offset part of the Section 1250 ordinary gain and his \$35,000 casualty loss deduction to offset the rest of his ordinary income gain. Therefore in 2014, George has \$5,000 of net investment income for the net investment income tax; \$0 net gain plus \$5,000 of dividends and interest. His results in 2015 are the same as in Example 18.
- d. Management Fee
- 1) A large advisory fee for managing a stock portfolio can only offset "net investment income" to the extent it exceeds 2% of AGI as a miscellaneous itemized deduction.
 - 2) Investment interest expense can only be used to offset "net investment income" to the extent otherwise allowed on Form 4952.
- e. State or Local Taxes
- 1) Any state or local tax attributable to the sources of net investment income may be deducted in computing net investment income.
 - a) Must allocate state or local taxes to various types of income.
21. The proposed regulations put the transferor of a passthrough entity in a similar position as if the partnership or S corporation has disposed of all of its properties and then passed its gain or loss through to its owners. Proposed Reg. 1.1411-7(b) provides the calculation for determining the amount of the transferor's gain or loss under Section 1411 from the disposition of an interest in a passthrough entity.
- a. For dispositions resulting in chapter 1 gain, the transferor's gain equals the lesser of:
 - 1) The amount of gain the transferor recognizes for chapter 1 purposes , or
 - 2) The transferor's allocable share of net gain from a deemed sale of the passthrough entity's Section 1411 property (property which, if sold, would give rise to gain or loss that is includible in determining the transferor's net investment income under Reg. 1.1411-4(a)(1)(iii)).
 - b. The proposed regulations contain a similar rule when a transferor recognizes a loss for chapter 1 purposes.
22. Example 21. Todd owns one-half interest in Alpha, a calendar-year partnership. In Year 1, Todd sells his interest for \$200,000. Todd's adjusted basis for the interest sold is \$120,000. Thus, Todd recognizes \$80,000 of gain from the sale (chapter 1 gain). Alpha is engaged in three trade or business activities, X, Y, and Z, none of which are trading in financial instruments or commodities. Alpha also owns marketable securities.

For Year 1, Todd materially participates in Activity Z, thus it is not a passive activity trade or business of Todd. Todd, however, does not materially participate in activities X and Y, so these activities are passive trades or businesses of Todd. Because Alpha is engaged in at least one trade or business and at least one of these trades or businesses is not passive to Todd, Todd determines his amount of Sec. 1.1411-4(a)(1)(iii) gain or loss from net investment income under Reg. 1.1411-7.

The fair market value and adjusted basis of the gross assets used in Alpha's activities are as follows:

	Adjusted basis	Fair Market Value	Gain/Loss	Todd's Share Gain/Loss
X (passive as to Todd)	\$136,000	\$96,000	(\$40,000)	(\$20,000)
Y (passive as to Todd)	60,000	124,000	64,000	32,000
Z (nonpassive as to Todd)	40,000	160,000	120,000	60,000
Marketable securities	<u>4,000</u>	<u>20,000</u>	<u>16,000</u>	<u>8,000</u>
Total	\$240,000	\$400,000	\$160,000	\$80,000

Todd must determine the portion of gain or loss from the sale of Alpha's Section 1411 property allocable to Todd. Todd's allocable share of Alpha's Section 1411 property is \$20,000 (\$20,000 loss from X + \$32,000 gain from Y + \$8,000 from the marketable securities). Because the \$20,000 allocable to Todd from a deemed sale of Alpha's Section 1411 property is less than Todd's \$80,000 chapter 1 gain, Todd will include \$20,000 under Reg. 1.1411-4(a)(1)(iii).

23. Example 22. Assume the same facts as Example 21, but Todd materially participates in activities Y and Z and does not materially participate in activity X. Todd's allocable share of Alpha's Section 1411 property is a \$12,000 loss (\$20,000 loss from X + \$8,000 from the marketable securities). Because Todd sold his interest for a chapter 1 gain, the amount allocable to Todd from a deemed sale of Alpha's Section 1411 property cannot be less than zero. Accordingly, Todd includes no gain or loss under Reg. 1.1411-4(a)(1)(iii).

24. Optional Simplified Reporting

- a. A transferor of an interest in a passthrough entity may use a simplified reporting system if it satisfies the eligibility requirements.
- b. To qualify, the seller must satisfy at least one of two quantitative tests:
 - 1) Test #1: The taxpayer must satisfy both of these requirements:
 - a) The cumulative sum of net investment income allocated to the selling member in the year of sale and the two preceding years must be less than 5% of the sum of all items of income, gain, loss, and deduction allocated to the seller over that period.
 - (1) Any losses and deductions are included as a positive number.
 - b) The total amount of chapter 1 gain recognized on the sale of the membership interest must be less than \$5 million.
 - 2) Test #2: The total amount of chapter 1 gain recognized on the sale of the membership interest must be less than \$250,000

c. Simplified Method

- 1) Multiply the chapter 1 gain from the sale of the membership interest by the following fraction:
 - a) The sum of all net investment income or loss allocated to the seller over the previous three years
 - (1) Any losses are counted as a negative number and offsetting the income.
 - b) The sum of all items allocated to the seller over the previous three years.

- d. Example 23. Todd owns a one-half interest in Alpha, a partnership. In Year 1, Todd sells the interest for \$2,000,000. Todd's adjusted basis for the interest sold is \$1,100,000. The aggregate net income from Alpha's activities allocable to Todd for the year of disposition and the two preceding tax years are as follows:

X (nonpassive to Todd): \$1,800,000
 Y (passive to Todd): (\$10,000)
 Marketable securities: \$20,000

Because Todd's sale of the partnership interest generates gain of \$900,000, Test #2 is out.

Over the three year period, Todd was allocated \$30,000 of items that constitute net investment income: (\$10,000 loss from activity Y and \$20,000 of income from marketable securities).

The total amount of Todd's allocated net items during the three-year period was \$1,830,000 (\$1,800,000 income from activity X, \$10,000 loss from activity Y, and \$20,000 income from marketable securities). Thus, less than 5% ($\$30,000 / \$1,830,000$) of Todd's allocations during the three-year period represented net investment income. As a result Todd can use the optional simplified method.

Because Todd qualifies to use the optional method, Todd may skip the deemed asset sale steps. Instead, Todd may take his \$900,000 gain on the sale of the interest and multiply it by the following fraction: $\$10,000$ (the \$10,000 of passive Y loss and \$20,000 of marketable securities income allocated to Todd) divided by $\$1,810,000$ (the cumulative income and loss allocated to Todd).

Todd multiplies \$900,000 by .005 to reach a product of \$4,972. This is the amount of the \$900,000 gain on the sale of the partnership interest that A must include in net investment income.

25. For Income to be Excluded from Net Investment Income

- a. The income must be earned in a "trade or business,"
- b. The income must be earned in the "ordinary course of a trade or business,"
- c. The trade or business cannot be the trading of financial instruments or commodities, and
- d. The individual must not be a passive investor in the business.

26. Individuals may owe both the Additional Medicare Tax and the Net Investment Income Tax, but not on the same income.
 - a. Example 24. Lynda, a single individual, works for Allied Mechanics for the year and is paid \$300,000. In addition, she has \$150,000 net investment income. Her modified adjusted gross income is \$450,000. Lynda's Additional Medicare Tax on her wages is \$900; the \$300,000 of wages minus the \$200,000 threshold for a single individual times 0.9%. In addition, the Net Investment Income Tax is \$5,700; which is the \$150,000 net investment income times the 3.8%.
27. 3.8% tax is computed on Form 8960, Net Investment Income Tax – Individuals, Estates, and Trusts and shown on line 60 of Form 1040 as Other Taxes.
28. Tax Planning Tips:
 - a. Materially participate in S corporations
 - b. Invest in tax-favored retirement plans
 - c. Purchase tax-exempt bonds
 - d. Transfer interests in passthrough entities to family members
 - e. Use of insurance and deferred annuities
 - f. Installment sales
 - g. Like-kind exchanges
 - h. Take capital losses and match capital gains and losses
 - i. Defer capital gains to years below MAGI threshold
 - j. Grouping passive activities
 - k. Charitable Remainder Trusts
 - l. Converting taxable compensation to tax-free fringe benefits
 - m. Donating an IRA to charity
 - n. Income smoothing
 - o. Separate filing

D. Increased Threshold for Medical Expenses

1. Medical expenses must exceed 10% of adjusted gross income to qualify for a deduction.
 - a. Remains at 7.5% for those over age 65 through 2016.
 - b. The alternative minimum tax threshold remains at 10%.
2. Will most harm near retirees and those with modest incomes but high medical bills.

E. Limit on Health Flexible Spending Accounts

1. Maximum of \$2,500 allowed as contributions to health Flexible Spending Accounts.
 - a. Reduces Box 1 amount on W-2.
 - b. Prior to 2013, the accounts were allowed unlimited contributions.
 - 1) Employer was allowed to impose a contribution limit.
2. It is with a cafeteria plan through Section 125 that an employee sets up a health care flexible spending account using pre-tax dollars. Section 125 is used to set up other pre-tax contributions, such as health savings accounts, health reimbursement accounts, flexible spending dependent care, contributions to 401(k) plans, etc.
3. Used to pay a family's basic medical needs.
4. 30 to 35 million taxpayers make contributions to FSAs.
5. Families with special need children are hit the hardest.
 - a. FSA amounts can be used to pay for special needs education.
 - 1) Tuition rates for schools that teach special needs children can exceed \$14,000 per year.
6. The statutory \$2,500 limit under §125(l) applies only to salary reduction contributions under a health FSA, and does not apply to certain employer non-elective contributions (sometimes called flex credits), to any types of contributions or amounts available for reimbursement under other types of FSAs, health savings accounts, or health reimbursement arrangements, or to salary reduction contributions to cafeteria plans that are used to pay an employee's share of health coverage premiums (or the corresponding employee share under a self-insured employer-sponsored health plan). [Notice 2012-40]
 - a. Employee contributions to health insurance premiums are not included in the \$2,500 health care flexible spending account maximum.
7. If each of two spouses is eligible to elect salary reduction contributions to an FSA, each spouse may elect to make salary reduction contributions of up to \$2,500 (as indexed for inflation) to his or her health FSA, even if both participate in the same health FSA sponsored by the same employer. [Notice 2012-40]

F. Indoor Tanning Salons

1. A 10% excise tax applies to tanning services provided after June 30, 2010. [Sec. 5000(B)(a)]
2. The excise tax is imposed on the total amount paid by an individual for indoor tanning service, including any amount paid by insurance. [TD 9486]
3. Full payment is due at the time the provider timely files Form 720, Quarterly Federal Excise Tax Return.
 - a. All indoor tanning service providers who do not have an EIN must acquire an EIN in order to file and remit the tax due on Form 720.
 - b. A separate form must be filed for each establishment with its own EIN.
4. The cost of other goods may be excluded from the excise tax if they are separable, do not exceed the fair market value of such other goods, and are shown in the exact amounts in the records pertaining to the indoor tanning service charge.
 - a. If the charges are not separately stated, but the total amount paid covers indoor tanning services, then the tax is based on the portion of the amount paid that is reasonably attributable to the indoor tanning services. [TD 9486]
5. If an invoice shows bundled services that include indoor tanning services, the service provider calculates the tax using a ratio based on the non-bundled price of each service. If the provider does not normally charge for a certain service separately, the provider should use the fair market value for purposes of this calculation. To create the ratio, divide the non-bundled price for the indoor tanning services by the charge for the total non-bundled price of all services in the bundle and apply that ratio to the bundled charge to obtain the taxable amount. The tax is 10% of the taxable amount. If the invoice shows bundled services that include unlimited indoor tanning services, the service provider calculates the tax the same way.
 - a. Example 25. A salon operator offers a special bundle price for 10 swimming lessons and two “free” indoor tanning services for \$200. Outside of the bundled service, the operator charges \$20 for each swim lesson and \$15 for each tanning service, for a total regular charge of \$230. The amount subject to tax for the bundled service is computed as $\$30/\$230 \times \$200 = \26.08 . The indoor tanning tax is 10% of \$26.08, which is \$2.61.
6. Any payment that is received in exchange for unspecified services is not subject to tax at the time of payment (such as the sale of a gift certificate). When the holder of the gift certificate exchanges the gift certificate for indoor tanning services, the provider will determine and collect any tax due on the indoor tanning services.

7. If the invoice does not separately state the tax, then the amount shown is presumed to include the indoor tanning tax amount. The provider multiplies the invoice amount by .0091 to obtain the tanning tax.
 - a. Example 26. The invoice shows a \$15 charge for indoor tanning service. The provider should remit \$1.36 for indoor tanning services tax ($\$15 \times .09091$) and apply \$13.64 ($\$15 - \1.36) to the actual tanning service.
8. Certain medical procedures are exempt from the excise tax. These include phototherapy service for the treatment of dermatological conditions, sleep disorders, seasonal affective disorder, or other psychiatric disorders; neonatal jaundice; wound healing; and other qualified procedures.
 - a. If performed by a licensed medical professional on the medical professional's premises.
9. No portion of a membership fee is subject to the tax if the facility meets the definition of a qualified physical fitness facility.
 - a. In this case, the indoor tanning service is treated as incident to the physical fitness facility's predominant business and no liability for the excise tax attaches.
 - b. A tanning salon cannot qualify as a Qualified Physical Fitness Facility by allowing users access to exercise classes or equipment.
 - c. Qualified Physical Fitness Facility -- A facility (i) in which the predominant business or activity is providing facilities, equipment, and services to its members for purposes of exercise and physical fitness, (ii) indoor tanning services is not a substantial part of its business, and (iii) it does not offer tanning services to the public for a fee or offer different pricing options to its members based on indoor tanning services.