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LEGISLATIVE UPDATE

Eye on Washington

IRS ISSUES FINAL REGULATIONS ON "NET INVESTMENT INCOME" TAX

Among the tax provisions included in the 2010 Affordable Care Act was a significant new tax on the investment income of high income earners. The additional 3.8% income tax is the sum of the 2.9% Medicare tax rate plus the new .9% FICA tax on the wages of high income earners. The new tax applies to "Net Investment Income" earned in 2013 and later years. Thus, taxpayers will have to report the tax for the first time on their 2013 tax returns.

Final rules (along with some new proposed regulations) on the investment income tax were published on December 2, 2013. They carry forward the favorable treatment of benefit plan-related income, and clarify several issues affecting employee stock ownership plan (ESOP) distributions.

Who Is Subject to the Tax?

Individuals who are (1) U.S. citizens and residents, with (2) "net investment income," and (3) modified adjusted gross income over the following thresholds (not indexed for inflation) are subject to the additional tax:

Filing Status	Threshold Amount
Married Filing Jointly	$250,000
Married Filing Separately	$125,000
Single or Head of Household	$200,000

What Is Net Investment Income?

In general, investment income includes interest, dividends, capital gains, rental and royalty income, taxable distributions from nonqualified annuities, income from businesses involved in trading financial instruments or commodities, and income from passive activities. However, income derived in the ordinary course of an active trade or business is generally exempt. To calculate net investment income, the investment income is reduced by certain expenses properly allocable to the income, including investment income expense, investment advisory and brokerage fees, expenses related to rental or royalty income, and state and local income taxes. However, tax advisors are still awaiting further IRS guidance on how to calculate certain expenses and write-offs for the state and local taxes that may be subtracted from investment income when calculating the tax.

The tax does not apply to income that is excluded from gross income for regular income tax purposes (e.g., tax-exempt interest, life insurance proceeds, and certain gains from the sale of a principal residence). In general, all "wages," "self-employment income" (e.g., director's fees and insurance agent's commissions), alimony, and Social Security benefits are also exempt.

How Is Retirement Income Treated?

All income earned under – and all distributions from – tax-favored retirement plans (plans described in Code sections 401(a), 401(k), 403(a), 403(b), and 457(b)), and from IRAs (traditional, Roth, SEP, SARSEP, and SIMPLE), are exempt. This includes deemed distributions (e.g., loan defaults, Roth conversions), corrective distributions (e.g., "excess deferral" failure, excess IRA contributions), and any amount that is not treated as a distribution, but is otherwise includable in gross income from an IRA or qualified plan (e.g., "PS 58" costs from life insurance).

The final rules clarify, in a favorable manner, several issues affecting employer stock held under ESOPs and other qualified plans. Specifically –

- Qualified dividends on employer stock held under ESOPs, which are deductible by the employer under Section 404(k), are not subject to the new tax (even though other dividends are) when distributed to participants. However, after the employer stock has been distributed, dividends paid on the stock will be subject to the additional tax.

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- "Net unrealized appreciation" ("NUA") on employer stock is excluded from income at the time the stock is distributed in a qualified distribution – typically, in a total distribution, or to the extent the stock was purchased with after-tax employee contributions. Such "NUA" is also exempt from the tax on net investment income – even if it is later taxed when the stock is sold. However, any stock appreciation earned post-distribution is subject to the new tax.

It is important to note that, even if some of a qualified plan's investment income is taxable under the unrelated business income tax rules (e.g., rental income from a leveraged real estate investment under Code section 514), the new tax does not apply to the plan. The same goes for income earned by Voluntary Employees' Beneficiary Associations (VEBAs) and other trusts exempt under section 501 of the Code – as well as health savings accounts and qualified tuition savings accounts.

How Is the Tax Computed?

The tax equals 3.8% times the lesser of (i) a taxpayer's adjusted gross income threshold, or (ii) net investment income. Some examples –

- Taxpayer, a single filer, has wages of $180,000 and $15,000 of dividends and capital gains. Taxpayer's modified adjusted gross income is $195,000, which is less than the $200,000 statutory threshold. Taxpayer is not subject to the Net Investment Income tax.
- If a single taxpayer instead has $195,000 of wages and $15,000 of investment income (total AGI of $210,000), $10,000 of the investment income would be subject to the new tax – for an additional tax of $380.

How Is the Tax Reported and Paid?

Payers of net investment income are not required to withhold the tax. An individual reports and pays the tax with his or her Form 1040. The final rules confirm that the tax is also subject to the estimated tax provisions, including possible penalties for underpayment for 2013 (as well as future years). Therefore, if a material amount of net investment income is expected, the taxpayer should either increase income tax withholding (Form W-4/W-4P) or make estimated tax payments to avoid underpayment penalties.

In Summary

The new rules draw a clear line ensuring that income related to compensation for services – and to tax-favored retirement, education and health programs – will not be subject to the added burden of the new tax. However, the new tax may apply frequently to two-income couples with investment income. In light of the new tax, employers may wish to review their qualified and retirement programs to be sure they are as tax efficient as possible.

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