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### **New 2013 Medicare Surtax on Investment Income Affects Tax Planning**

For the first time, as of January 1, 2013, a 3.8 percent Medicare surtax (the “Surtax”) is imposed by Internal Revenue Code Section 1411 on the investment income of taxpayers that exceeds certain thresholds. Until now, Medicare taxes had been imposed on only earned income. Under the new rules, for individuals, the Surtax is imposed on the lesser of: (i) net investment income, or (ii) the excess of modified adjusted gross income above \$200,000 for individuals, \$250,000 for couples filing jointly and \$125,000 for spouses filing separately. The Surtax is imposed on trusts and estates as well. For these entities, it is imposed on the lesser of: (i) undistributed net investment income, or (ii) the excess of adjusted gross income over a threshold that is equal to the dollar amount at which the highest tax bracket for trusts and estates is reached. For 2013, this is \$11,950.

Net investment income includes only certain types of income. These generally include:

- gross income from interest, dividends, annuities and rents (other than rents derived in the course of a trade or business);
- gross income from a passive activity or the trade or business of trading in financial instruments or commodities; and
- net gains to the extent taken into account in computing taxable income.

Exclusion from net investment income is provided for distributions from qualified retirement plans. Income from tax-exempt bonds, as well as income earned by trusts otherwise exempt from income tax, is not subject to the Surtax. Income from an investment in a business operated as a limited liability company, partnership or S corporation will be considered passive for those investors who are not actively involved in the business and will be subject to the Surtax. However, for those investors who are actively involved in such a business, income will not be considered passive and will be excluded from net investment income.

The imposition of this new Surtax adds another factor that must be considered in tax planning. Depending upon a taxpayer’s situation, a taxpayer may wish to consider the following in planning for his or her transactions.

- The receipt of passive income by a taxpayer may have previously been viewed favorably because of the ability to offset such income with passive losses. Now, however, passive income is subject to the Surtax and taxpayers may want to look into ways to make such income active.
  - A taxpayer may wish to consider whether his level of activity may be increased so that the income generated is no longer considered passive and would therefore not be subject to the Surtax.
  - Consideration may also be given to how activities are aggregated to determine whether they are passive or active. Under proposed regulations, taxpayers are allowed to change the grouping of their activities on a one time basis.
- Characterizing more income as active may, however, have significant negative consequences if it causes such income to be subject to self employment taxes. To avoid this, consideration may be given to utilizing S corporations.
  - Under current authority, if reasonable compensation subject to employment tax is paid to S corporation shareholders who materially participate in the business, other distributions to such shareholders may be exempt from employment tax. *See* Revenue Ruling 59-221; Internal Revenue Code Section 1401(a)(2). Because these shareholders materially participate in the business, such distributions may also be excluded from net investment income and not be subject to the Surtax.
  - A business may be operated directly by an S corporation. S corporations, however, may have only one class of stock and have certain restrictions on shareholder qualification. In circumstances where preferred interests may be involved or shareholder qualification is an issue, an S corporation may instead become a member of a limited liability company or limited partnership. The active participants in the business could be the owners of the S corporation, while the passive investors could be direct members of the limited liability company or partnership.
- Taxpayer's who are thinking about transferring assets through the use of family partnerships or limited liability companies may now, in some situations, achieve an additional benefit from doing so. Investment income from such entities that is received by those younger family members who have lower income levels may not be subject to the Surtax.

- Taxpayer's may wish to utilize installment sales to reduce the amount of net gain received in any one year and thereby, in appropriate circumstances, reduce or eliminate the imposition of the Surtax.
- Where appropriate taxpayers may wish to consider structuring trusts as charitable remainder trusts since income earned by charitable interests is not subject to the Surtax.

The effects of the new Surtax and the choice of appropriate tax planning steps will depend upon a taxpayer's specific situation.

This memorandum is not legal advice, is only a summary of the matters addressed herein, and is intended for informational purposes only. Anyone interested in learning more about how the Surtax may impact his or her personal situation is encouraged to contact a tax advisor.

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*Pearl Doherty has substantial tax planning experience representing individuals, closely-held businesses and nonprofit organizations. Schell Bray PLLC, a law firm based in North Carolina with offices in Greensboro and Chapel Hill, focuses its practice on business, commercial real estate, and trusts and estates law.*