

3.8% Medicare Surtax Regulations

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There were a number of important unanswered questions when 3.8 percent Medicare surtax took effect on January 1, 2013. Proposed regulations issued on November 30, 2012 answered many of these questions. Following is a summary of some of the most important clarifications.

Charitable Remainder Trusts

Distributions from a charitable remainder trust (CRT) are taxed to beneficiaries under the ordering rules of IRC § 664. Under these rules, distributions are treated as made first from ordinary income, second from capital gains, third from other income and last from trust corpus. The proposed regulations create a new category for net investment income (NII), making it the first category distributed, in front of ordinary income. They also provide that only income received by a CRT after 2012 is subject to the surtax when distributed. This means that NII received by a CRT before 2013 is never subject to the surtax regardless of when it is received by trust beneficiaries (Prop. Reg. § 1.1411-3(c)(2)(iii)).

Passive Activity Grouping Rules

Grouping of activities can often make it easier to show material participation in a trade or business, but once activities have been grouped, the groupings can't ordinarily be changed. The proposed regulations include a special fresh start rule, allowing taxpayers to regroup in the first year they would be subject to the surtax. Unfortunately, this rule will not enable taxpayers to avoid the surtax by grouping rental activities with non-rental activities. Even if grouping the activities together creates material participation and makes the combined activity non-passive, the rental income continues to be treated as NII (Preamble to proposed regulations at section 6A(i)(b)(4)).

Properly Allocable Deductions

In calculating the amount of NII, taxpayers can reduce items of income and gain by properly allocable deductions. The proposed regulations provide the following guidance on determining allowable deductions.

- Deductions for a tax year can't exceed the amount of NII for the tax year (Prop. Reg. § 1.1411-4(h), Example 1).
- NOLs are not taken into account (Prop. Reg. § 1.1411-4(f)(1)(ii)).
- Section 62(a)(4) deductions allocable to rents and royalties are taken into account (Prop. Reg. § 1.1411-4(f)(2)).
- Section 62(a)(1) business deductions are taken into account to the extent not used in determining self-employment income (Prop. Reg. § 1.1411-4(f)(2)).

- Early withdrawal penalties are taken into account (Prop. Reg. §1.1411-4(f)(3)(i)).
- Investment interest expense, investment expenses, state and local taxes and foreign taxes are taken into account (Prop. Reg. § 1.1411-4(f)(iii)(C)).
- Deductions subject to the 2% floor on miscellaneous itemized deductions or the overall limitation on itemized deductions are deductible only to the extent allowable for income tax purposes (Prop. Reg. § 1.1411-4(f)(3)(ii)).
 - Example: Taxpayer has \$330,000 in taxable income, \$250,000 in wages and \$80,000 in NII. Taxpayer also has \$10,000 in miscellaneous itemized deductions attributable to NII.
 - 2% Floor limitation: $\$330,000 \times 2\% = \$6,600$ not deductible
 - 3% Pease limitation: $\$330,000 - \$300,000$ threshold = $\$30,000 \times 3\% = \900 not deductible
 - Only a \$2,500 miscellaneous itemized deduction is allowed ($\$10,000 - \$6,600 - \$900$)

Material Participation in Rental Activities

The general rule treating all real estate activities as per se passive does not apply to real estate professionals. Under the proposed regulations, however, even if a taxpayer qualifies as a real estate professional for purposes of the passive loss rules, the rental activity is still NII unless the rental activity rises to the level of a trade or business.

Deferred compensation

Employees are treated as engaged in the trade or business of being an employee. This means that amounts received as deferred compensation are not NII even if they include an interest component.

Proration of the ATA for Short Tax Years of an Individual

The threshold amount for applying the surtax is not prorated for a short taxable year unless there is a change of accounting method (Prop. Reg. §§ 1.1411-2(d)(2)).