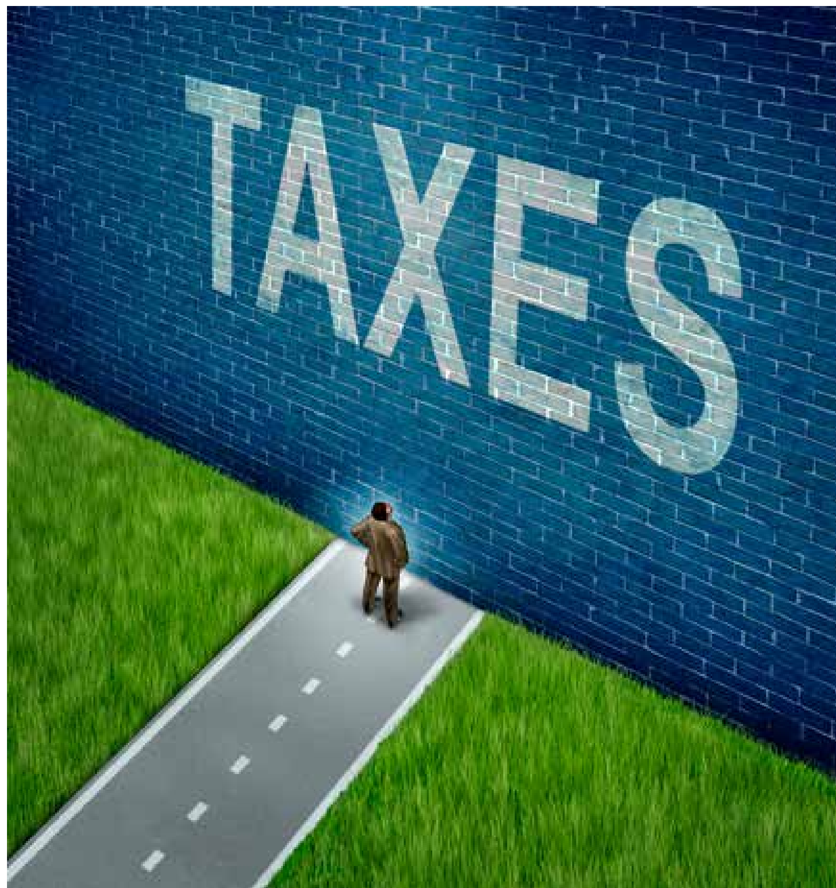
Understanding the net investment income tax

Learn how businesses and individuals can reduce their exposure to this new Medicare tax

By Ryan Kuenzi, CPA

As nurseries work their way back to profitability after a difficult downturn in the industry, it's important to understand how new regulations regarding net investment income tax (NIIT) — one of two taxes from the Affordable Care Act — will affect you.

While considered friendlier toward taxpayers than the earlier proposed regulations, certain steps and appropriate planning are advisable to significantly mitigate your exposure to the NIIT.



The basics

Higher income individuals are required to report and pay a 3.8 percent NIIT. This affects individuals, as well as certain estates and trusts, with modified adjusted gross income (MAGI) that exceeds certain thresholds.

The threshold amount for single individuals is $200,000. For married couples filing a joint return, it is $250,000. For those filing separately, it's $125,000. The head of a household is at a $200,000 threshold, while a qualified widow(er) with dependent child has a threshold of $250,000. The threshold for estates and trusts is significantly lower at $12,150 for the 2014 tax year (this threshold is subject to adjustment by the IRS on an annual basis).

If your income is over the threshold, your tax planning could be significantly affected.

The 3.8 percent tax applies to the lesser of net investment income or the excess of the taxpayer's MAGI over the threshold. This must be paid in addition to a taxpayer's regular income tax liability, or if applicable, alternative minimum tax liability.

Essentially, if your MAGI is below the applicable threshold, you aren't subject to the NIIT. Most taxpayers' MAGI will be the same as their adjusted gross income (AGI).

Affected income categories

The NIIT applies to three main categories of investment income. The total investment income in these categories can be reduced by properly allocable deductions, such as investment interest expenses, investment advisory and brokerage fees, and certain portions of your state and local taxes.

The categories are:

- **Traditional portfolio income.** This includes interest, dividends, annuities, rents and royalties. For nurseries and other companies related to agribusiness, this might mean that earnings on an investment account or rental income received from the cash rent of farmland to another agribusiness would be included. However, there is an exception if you rent the farmland that you own to an operating agribusiness entity that you also have common ownership in and control. ▶

• Trade or business income. This describes income from so-called passive investments, in which the taxpayer doesn't materially participate. If you enter into a transaction to sell your farming or nursery entity, for example, that sale could trigger NIIT if you don't materially participate in that entity.

• Gains. This includes capital gains and other gains from the sale of investments or passive property. For example, let's say you personally own 50 acres of excess land that isn't used in your nursery trade or business, but is leased out to a neighboring farmer on a cash rent basis. After careful consideration, you decide to sell this land to your neighboring farmer. The sale of this land potentially would be subject to NIIT.

The NIIT doesn't apply to the following types of income:

• Wages and self-employment income (though these may be subject to the new Medicare tax discussed below);

• Income earned in a nonpassive trade or business, and in the ordinary course of the trade or business;

• Distributions from pension, profit-sharing and stock bonus plans;

• Retirement account distributions, including 401(k)s, IRAs, nonqualified deferred compensation plans and Roth IRA conversions;

• Social Security income;

• Tax-exempt income from municipal bonds and Roth IRA distributions;

• Life insurance proceeds; and

• Excluded gain from sale of personal residence.

Defining material participation

The definition of material participation is critical because it indicates whether or not you'll owe NIIT.

Since income earned in a non-passive (that is, active) trade or business is exempt from the NIIT, the distinction between passive and non-passive income becomes an important one for many taxpayers looking for ways to reduce their tax exposure. There isn't a clear definition of trade or business from the Department of Treasury, so whether an activity is active or passive is based on facts and circumstances specific to each taxpayer.

Activities that don't meet the tests of material participation are considered passive and subject to the NIIT. For example, if you're a shareholder in an S corporation and you don't meet any of the tests for material participation, then all of the income you've earned from the corporation will be considered net investment income.

Becoming active might seem like the perfect solution to reducing your NIIT exposure, but keep in mind that the benefits can vary by individual and type of entity. For example, if you materially participate in an S corporation, then your share of ordinary income from the trade or business will not only be NIIT-free but also free of the self-employment tax — a great situation.

Material participation in an LLC, on the other hand, could result in different tax consequences, which need to be carefully considered by you and your tax advisor.

Generally, as long as the activity — whether separate or grouped — isn't passive to you, then trade or business income from that activity can be excluded from your net investment income. However, the final determination requires a discussion and review of your particular facts and circumstances with your tax advisor.

Grouping and regrouping benefits

It's critical that taxpayers with multiple agribusiness activities consider making a grouping election. By grouping activities correctly, a taxpayer can effectively combine his or her hours

of participation. This could allow the activity to be considered non-passive, so that the trade or business income derived from it would no longer be subject to the NIIT.

Before the NIIT, a taxpayer who received net income from multiple business activities typically had no need to group activities, since the net income would be taxed regardless. Now, under the NIIT, income derived from passive activities could be subject to the 3.8 percent tax. As a result, activity grouping factors far more prominently in tax planning decisions; it can make the difference in whether a given activity is characterized as passive or active and whether the resulting income will be subject to the NIIT.

Once activities are grouped, they can't be regrouped in future years, as this is a one-time opportunity provided by the IRS. Note that only individuals and trusts are allowed to regroup activities; pass-through entities aren't allowed to regroup.

Self-rental income and self-charged interest

In a change from proposed regulations, these two forms of income are excluded from NIIT in the IRS's final regulations.

• **Self-rental real estate income.** When a taxpayer rents real estate to a similarly owned pass-through trade or business that he or she materially participates in, it's treated as non-passive and can be excluded from net investment income.

For nursery business owners, the exemption for self-rental income is key because so many separate their real estate holdings from the business operations for a variety of reasons. However, for purposes of the NIIT, the rental property and operating business can be considered as a whole. This allows the taxpayer to reduce exposure to the NIIT as long as he or she is active in the business and meets the test of material participation.

• **Self-charged interest.** Similarly, ▶

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interest income from shareholder or member loans to their pass-through trades or businesses is now also excluded from the NIIT to the extent of the shareholder or member's allocable share of the interest expense.

Selling a pass-through entity

The regulations provide specific rules for calculating the net investment income of non-passive business owners who have sold (or are considering selling) an interest in their S corporation stock or partnership holding. In many cases, the business owner must calculate the gain on an asset-by-asset basis from a "deemed sale." Note that a non-passive seller might still be liable for the NIIT from the gain.

In contrast, gains from selling C corporation stock on a passive investment will always be considered net investment income tax — not an ideal outcome.

The additional Medicare tax

The second new tax enacted with the Affordable Care Act is the 0.9 percent additional Medicare tax. If you're self-employed, you may also be subject to this tax, which applies to self-employment income as well as regular wages, to the extent it exceeds the same thresholds as the NIIT. These thresholds are $250,000 for joint filers, $125,000 for married taxpayers filing separately, and $200,000 for individuals, heads of household and other filers.

Unlike regular Medicare taxes, the new 0.9 percent Medicare tax doesn't include a corresponding employer portion. Your employer is, however, obligated to withhold the additional tax to the extent that your wages exceed $200,000 (regardless of filing status) in a calendar year.

What now?

The 3.8 percent NIIT could significantly impact your tax planning. Work through the potential tax impacts as you choose your entity structure — C corporation versus S corporation versus partnership. Additionally, the NIIT tax can catch many people by surprise when executing on your ownership succession and transitional plans. Contact your tax professional to learn more and to discuss your particular planning options.

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