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### REMINDER - 3.8 % SURTAX ON INVESTMENT INCOME STARTING IN 2013

The Health Care and Education Reconciliation Act of 2010 added a 3.8 percent surtax effective for years beginning after December 31, 2012.

The 3.8 percent surtax is imposed on the lesser of: (1) an individual's net investment income for the tax year, or (2) any excess modified adjusted gross income for the tax year over a threshold amount. The threshold is \$200,000 for individuals, \$250,000 for married filing jointly and \$125,000 for married filing separately.

Net investment income is the excess of the sum of the following items less any otherwise allowable deductions properly allocable to such income or gain:

- gross income from interest, dividends, annuities, royalties and rents unless such income derived is in the ordinary course of any trade or business (for this purpose, income derived in the ordinary course of a trade or business excludes any trade or business that is either a passive activity of the taxpayer (within the meaning of code section 469), or involves trading in financial instruments and commodities (as defined in code section 475(e)(2)));
- other gross income from any passive trade or business; and
- 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 (Code sections 1411(c)(1) and (2), as added by the 2010 Reconciliation Act).

Gross income does not include items that are otherwise excluded from income, such as interest from tax exempt bonds, excluded gain from the sale of a principal residence, or veteran's benefits.

The Act refers to the definition of passive activities under Code section 469. Under section 469 rental activities are per se passive. There is an exception for property rented to a related *flow-through entity (such as an S corporation or partnership) in which the taxpayer materially participates*. In this case the rental income is reclassified as nonpassive income and therefore the 3.8% surtax does not apply. **The 3.8% surtax would apply however if the property were rented to a related C corporation.**

When computing net investment income, losses from passive activities should be included in the computation to the extent that the losses are deductible on the taxpayer's return for that year. This means that passive losses can offset passive income for purposes of computing net investment income. Capital losses and loss carryforwards should be able to offset capital gains realized in the same tax year.

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#### EXAMPLE 1 - SINGLE TAX PAYER WITH NET INVESTMENT INCOME

Taxpayer has taxable wages of \$350,000 and net investment income of \$80,000. The surtax will be imposed on the lesser of modified adjusted gross income over the threshold or net investment income. Their modified adjusted gross income is \$430,000 or \$230,000 over the threshold of \$200,000. Their net investment income is \$80,000 therefore the additional surtax will be  $\$80,000 \times 3.8\%$  or \$3,040.

#### EXAMPLE 2 - MARRIED FILING JOINTLY WITH NET INVESTMENT INCOME

Taxpayer and Spouse do not have any wages. Their combined net investment income is \$300,000. Their modified adjusted gross income over the threshold is \$50,000 (\$300,000 less \$250,000 married filing jointly). The surtax will be  $\$50,000 \times 3.8\%$  or \$1,900.

#### EXAMPLE 3 – SELF RENTED RENTAL REAL ESTATE TO S CORPORATION

Taxpayer owns 100% of a S corporation that is engaged in manufacturing. Taxpayer materially participates in the S corporation. Taxpayer has wages of \$150,000 and flow through profit of \$250,000. Additionally Taxpayer personally owns the building and real estate that the S corporation operates from. Taxpayer's net income from the rental of the building is \$50,000 per year. The Taxpayer does not have any other sources of income. For purposes of section 469, since this is self-rented property it will not be treated as passive investment income and will not be subject to the surtax.

Note that Example 3 would change if the operating company was a C corporation or if the taxpayer did not materially participate in the S corporation's activity. In this case the net rental income would be treated as passive income for purposes of section 469 and would be subject to the surtax.

Note that the surtax on net investment income is in addition to the 0.9% surtax on wages and self-employment income over the threshold (discussed separately).

The additional surtax on net investment income will also apply to estates and trusts.

If there are no further tax law changes eliminating or modifying the surtax, the surtax will go into effect on January 1, 2013. The surtax could have significant tax implications on your investment income. Additionally the Bush tax cuts for capital gains and qualified dividend income are set to expire December 31, 2012. If these cuts expire, the long term capital gain rate will be 20% and qualified dividends will be taxed as ordinary income at rates up to 39.6% in addition to the surtax.

The **FGMK** tax department can assist you in navigating through the imposition of the surtax.

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