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New 3.8% "Affordable Care Act" Tax May Burden Some S Corporation Shareholders

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Electing small business trusts ("ESBTs"), which already pay federal income tax at the highest marginal rate on every dollar of taxable income, could face an additional 3.8% levy on certain forms of income recognized in 2013 and beyond, thanks to the 2010 health care reform legislation. As a result, income from an S corporation that is treated as passive activity income in the hands of one or more of its shareholders may be subject to federal income tax rates as high as 43.4 percent.

Background

Section 1411, which was added to the Internal Revenue Code (the "Code") as part of the 2010 health care reform legislation commonly known as "Obamacare" and is effective for taxable years beginning after December 31, 2012, imposes a 3.8% surtax on the "net investment income" of certain individuals, estates, and trusts. Calculating the amount of the tax is complicated enough in the case of an individual owning S corporation stock directly. Among other things, the individual must determine (a) the number of separate trade or business activities in which the S corporation is deemed to engage and (b) whether the individual materially participates in one or more of them. If the S corporation income attributable to the individual shareholder is characterized as being from an activity that is a passive activity with respect to the shareholder, the income will be subject to the 3.8% surtax (in addition to all other taxes), but only if the individual's gross income, subject to certain adjustments, exceeds the applicable threshold amount (e.g., $250,000 in the case of a married taxpayer who files a joint return).

Determining whether the surtax applies becomes significantly more complicated and less certain in the case of an ESBT. This issue of Tax Talk focuses on the impact of the 3.8% surtax on ESBTs and suggests ways in which an ESBT may be able to minimize the tax.[1]

Application of the 3.8% Net Investment Income Tax to ESBTs

In the case of an ESBT, the 3.8% surtax is imposed on the lesser of:

- the trust's undistributed net investment income (described below) for the taxable year, or
- the excess, if any, of the trust's adjusted gross income, over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year.

For taxable years beginning in 2013, the highest tax bracket for estates and trusts applies to all income in excess of $11,950.

ESBTs are treated as having two separate “portions” for income tax purposes. One portion is deemed to hold the S corporation shares and is required to pay tax on its allocable share of S corporation net income and gain. The other portion is deemed to hold all other trust assets (*e.g.*, distributions of earnings received from the S corporation which are not distributed by the trust to its beneficiaries but are instead added to trust corpus) and is subject to the rules applicable to other complex trusts. Complex trusts generally pay tax on their undistributed net income and gain that is allocated to trust principal, while the beneficiaries are taxed on the items that are distributed to them by the trust.

The S portion and non-S portion of an ESBT are treated as separate trusts for purposes of computing an ESBT’s undistributed “net investment income,” but they are treated as a single trust for purposes of determining the amount subject to tax under Section 1411. Accordingly, the S portion and non-S portion of an ESBT must compute their respective undistributed net investment income as separate trusts, and then combine these amounts to arrive at total undistributed net investment income. An ESBT’s adjusted gross income is equal to the non-S portion’s adjusted gross income, increased or decreased by the net income or loss of the S portion, after taking into account all deductions, carryovers, and loss limitations applicable to the S portion. The ESBT then will pay the additional 3.8% tax on the lesser of (i) its undistributed net investment income, or (ii) the excess of its adjusted gross income over $11,950 (which amount will be indexed annually for inflation).

EXAMPLE: Assume that in 2013 the non-S portion of an ESBT earns dividend income of $15,000, interest income of $10,000, and short-term capital gain of $5,000. Assume, further, that the S portion of the ESBT has net rental income of $21,000 and a long-term capital loss of $7,000. During 2013, the ESBT makes a distribution to a beneficiary of $9,000.

The first step in computing the ESBT’s net investment income is to separately calculate the undistributed net investment income of the S portion and the non-S portion of the ESBT. In this example, the S portion’s undistributed net investment income is $21,000. None of the $7,000 capital loss is allowed because net gain cannot be less than zero for these purposes, and excess capital losses are not “properly allocable deductions” for purposes of computing net investment income. Moreover, no part of the $9,000 distribution is allocable to the S portion of the ESBT. The non-S portion’s undistributed net investment income is also $21,000, calculated as follows:

Dividend Income:	$15,000
Interest Income:	$10,000
Capital Gain:	$5,000
Distributable Net Income Distribution:	($9,000)
Total	$21,000

The ESBT must then combine the undistributed net investment income of the S portion and the non-S portion. In this case, the ESBT’s combined undistributed net investment income is $42,000.

The second step is to calculate the ESBT’s adjusted gross income, which is equal to the non-S portion’s adjusted gross income, increased or decreased by the net income or net loss of the S portion. In this instance, the ESBT’s adjusted gross income would be $39,000, calculated as follows:

Dividend Income:	$15,000
Interest Income:	$10,000
Capital Gain:	$5,000
Distributable Net Income Distribution:	($9,000)
Net Income of S Portion	$18,000
Total	$39,000

The net income of the S portion of the ESBT is determined by starting with the net rental income of $21,000 and reducing it by the allowable portion of the net capital loss, or $3,000.[2] Note that the $7,000 long-term capital loss of the S portion of the ESBT cannot be netted against the $5,000 long-term capital gain of the non-S portion, according to the applicable regulations under Section 1411. In this example, the ESBT's adjusted gross income would be $39,000.

The ESBT will pay tax on the lesser of (i) its combined undistributed net investment income (e.g., $42,000), or (ii) the excess of its adjusted gross income ($39,000) over the dollar amount at which the highest tax bracket applicable to estates and trusts begins for the taxable year ($11,950). In this example, the ESBT's 3.8% surtax would be $1,027.90, or 3.8% of $27,050 ($39,000 - $11,950).

The statutory definition of "net investment income" is complex but effectively includes the following forms of income:

- Gross income from passive activities (as defined in the Code);
- Portfolio income (*e.g.*, interest, dividends, annuities, royalties, and rents), unless derived in an active trade or business);
- Gross income from a trade or business of trading in financial instruments or commodities; and
- Net taxable gain from the disposition of assets held in any of the above activities.

Net investment income does not include (a) gross income derived in a trade or business that is *not* a passive activity with respect to the taxpayer (other than a trade or business of trading in financial instruments or commodities), or (b) gains from the sale of assets that are held in any such trade or business.

When an individual, estate, or trust owns an interest in a trade or business that is conducted through a pass-through entity such as an S corporation, the determination of whether income earned by the business is derived in a passive activity is made at the "owner" (*i.e.*, shareholder) level. For example, assume that AB Corporation, an S corporation the stock of which is owned in equal shares by A and B, owns and operates a restaurant. A materially participates in the business as its day-to-day operator, while B is not active in the business but is merely an investor. In 2013, AB Corporation earns a profit of $1,000, which is allocated $500 each to A and B. Since A materially participates in the business, A's share of the income is not net investment income subject to the 3.8% surtax, but B's share of the income is subject to the surtax provided B has sufficient adjusted gross income (*e.g.*, at least $250,000 if B is married and files jointly). Likewise, in the case of an ESBT, the determination of whether income from the S portion of the trust is active or passive depends upon whether the ESBT is active or passive in the trade or business carried on by the S corporation in which the ESBT owns stock.

How does an ESBT determine whether its share of income from a trade or business carried on by an S corporation is active or passive? There is considerable uncertainty on this issue since

neither the Treasury nor the IRS has issued any guidance. Generally, whether an activity is active or passive with respect to a taxpayer is determined under the passive loss rules contained in Section 469 of the Code and the regulations thereunder. The passive loss rules also apply for purposes of determining whether an activity is active or passive under Section 1411.

A passive activity means any activity that involves the conduct of a trade or business and in which the taxpayer does not "materially participate." Generally, a taxpayer materially participates in an activity if the taxpayer participates on a regular, continuous, and substantial basis. The IRS has promulgated detailed regulations that address whether an individual materially participates in an activity. Perhaps the most common method is the so-called 500-hour test, whereby an individual is treated as materially participating in an activity if he or she participates in the activity for more than 500 hours during the taxable year, assuming that the nature of the participation is of a type customarily performed by an owner.

However, the 500-hour test and the other tests outlined in the regulations do not apply to complex trusts, and taxpayers have never received any formal guidance to determine when a trust (or estate) is considered to materially participate in an activity, although the applicable legislative history states that the determination is made with reference to the actions of the trustee. As a further complication, the IRS and the courts disagree as to how to determine whether a trustee is materially participating. The IRS takes the position that a trust materially participates in an activity only when its trustee, in his capacity as trustee, personally participates in the activity on a regular, continuous, and substantial basis. However, a U.S. District Court has held that a trust's material participation must be judged by reference to the activities of all of the persons who conduct the trade or business on behalf of the trust.[3] Under this more lenient standard, a trust's material participation is tested not only with reference to the activities of its trustee, but also with respect to the activities of its employees and agents. The IRS has specifically rejected this approach.[4]

Planning Opportunities

An ESBT should be able to avoid the 3.8% surtax on net investment income by designating as a trustee a person who materially participates, on behalf of the trust, in the trade or business activities carried on by the S corporation. Stated differently, the trustee's material participation in the business should be attributed to the trust, transforming the ESBT's share of S corporation income from passive to active with respect to the ESBT. However, a recent Technical Advice Memorandum ("TAM") from the IRS National Office suggests that, at least under the IRS's interpretation, it will be all but impossible for a trust to materially participate in a trade or business. The TAM is particularly noteworthy because the IRS has not issued regulations regarding a complex trust's active participation in a trade or business for purposes of applying the passive activity loss rules for more than 20 years.

In the TAM, which was published on January 18, 2013, the same individual served as the president of a company that carried on a business and was organized as a qualified subchapter S subsidiary (a "QSub") and as the special trustee of two trusts that owned stock in the QSub's parent. The IRS concluded that the work performed by the individual as an employee of the QSub was not in his role as a fiduciary of the trusts and therefore did not count for purposes of determining whether the trusts materially participated in the trade or business of the QSub or its parent. Instead, IRS held that only the time the individual spent serving as a special trustee, e.g., voting the stock or considering sales of stock of the QSub and its parent, would count for purposes of determining the trusts' material participation. Although the TAM did not address Section 1411, we expect that the IRS will take a similar position with respect to the 3.8% surtax imposed under Section 1411.

The TAM's reasoning and conclusion are troubling because they suggest that an ESBT will never be treated as materially participating in a trade or business carried on by an S corporation. Indeed, if material participation is determined strictly by reference to a trustee's actions on behalf of a trust — *e.g.*, voting the stock held by the trust or considering a sale of the stock — without any regard for a trustee's activities as an owner or manager of the business, it is hard to imagine that any trust or trustee could meet this test. Ultimately, taxpayers may be required to litigate to determine whether an ESBT or other complex trust is treated as active or passive with respect to trade or business income.

Other unanswered questions include:

1. If an ESBT has more than one trustee, must all trustees materially participate in the S corporation's trade or business, or it sufficient that at least one trustee materially participates?
2. Does it matter that the beneficiaries have the power to replace the active trustee or trustees?
3. Must there be a business purpose for replacing the trustee of an existing trust who is not materially participating in the S corporation's business with one who is?

These issues apply to existing trusts but also should be taken into account when designing new trust documents. Moreover, where it appears that an ESBT will not be treated as active with respect to a trade or business but one or more of its beneficiaries is active in the business, it may be advisable to consider whether the ESBT can qualify as a qualified subchapter S trust or a grantor trust and, if it cannot, whether the ESBT can or should distribute stock out of the trust.

Conclusion

The new 3.8% surtax on net investment income has particular relevance for ESBTs, which already pay the top marginal income tax rate on every dollar of income. Although proposed regulations offer some general guidance, there still is uncertainty as to how the tax will apply to ESBTs holding shares of S corporations engaged in business activities. In particular, it is not clear how ESBTs are to determine whether their income from a trade or business carried on by an S corporation is active or passive. We will continue to monitor this issue and will provide future updates as the application of the new 3.8% surtax becomes clearer.

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1 Similar issues are raised for other flow-through entities such as limited liability companies and partnerships. But those entities do not have the same restrictions on ownership that apply to eligible shareholders of S corporations. Interests in other flow through entities can be held by complex trusts that are taxed differently than ESBTs and will be the subject of a future issue of Tax Talk.

2 Each year, $3,000 of net long term capital loss may be used to offset ordinary income.

3 *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D. Tex. 2003).

4 I.R.S. P.L.R. 200733023, *supra* at n.14.

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