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Uncertainty Over Interpretation of the Unearned Income Medicare Contribution Tax

-by Neil E. Harl*

As should have been expected when a new tax is enacted that does not track the contours of tax legislation then in place, the interpretation of the numerous provisions is likely to trigger numerous questions of who must pay the new tax.¹ Although the 3.8 percent tax is paid, beginning in 2013, only by couples filing a joint return or a surviving spouse who earn more than \$250,000 (\$125,000 for married taxpayers filing separately) and \$200,000 for other taxpayers,² the additional tax burden has not gone unnoticed. As is often the case, the greater concern is in figuring out which “unearned income” is reached by the tax.

Issues relating to cash renting

As is now widely known, income received under a cash rent lease (for which no self-employment tax is paid) is subject to the 3.8 percent tax as “rents”³ other than income derived in the ordinary course of a trade or business.⁴ Share rents, for which the 15.3 percent self-employment tax has been paid, are not subject to the 3.8 percent levy. For many, who cash rent their land, the cash rent income may not be subject to tax because it does not reach the threshold for reporting and paying the tax. However, gains from real estate that has been cash rented before sale are likely to be subject to the tax and the amount of gain to be reported is likely, in many instances, to push the taxpayer (or taxpayers) into tax territory.

Some commentators have taken the position that an exception applies if the sale occurs within five years of retiring from active business involvement. That position is based on a subsection in another part of the Internal Revenue Code, Section 469(h)(3), which states –

“A taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of section 2032A would cause the requirements of section 2032A(b)(1)(C) (ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.”.

That provision routes the issue through the “material participation” part of the special use valuation statute where it is stated that “. . . ‘qualified real property’ means real property . . . which was being used in a qualified use by the decedent or a member of the decedent’s

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family if . . . during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which . . . there was material participation by the decedent or member of the decedent's family in the operation of the farm or other business. . . ."⁵

Expressions by the Department of the Treasury

The first question is whether the provision in I.R.C. § 469(h)(3) has been incorporated into the Health Care and Education Reconciliation Act of 2010.⁶ Nothing in the 2010 Act, the temporary regulations issued⁷ or the final regulations⁸ refer to I.R.C. 469(h)(3) specifically.

The second question is the meaning and scope of the commentary accompanying the final regulations.⁹ The Department of the Treasury acknowledges that regulations under I.R.C. § 469 do not “. . . affect the treatment of any item of income or gain under any provision of the Code other than section 469.”¹⁰ Also, the commentary makes the point clearly that Section 1411 does not embrace the “real estate professional” rules in I.R.C. § 469, for example, and notes I.R.C. § 469 provides 11 types of activities that constitute a real property trade or business and “. . . only a few of the 11 enumerated activities may be relevant in determining whether rents are derived in the ordinary course of the trade or business, such as the activities of “rental” and “leasing.”¹¹ It is clear that the Department of the Treasury has distanced itself in I.R.C. § 1411 from I.R.C. § 469 except where the two sections are, indeed, parallel. That hardly seems to be the case with I.R.C. § 469(h)(3).

So what does all of this mean?

Our advice, until further guidance is received in the form of rulings or cases, is to advise clients that there is risk in believing that I.R.C. § 469(h)(3) applies to the 3.8 percent tax rules of I.R.C. § 1411. Expressions to date by the Department of the Treasury in terms of sketching out the influence I.R.C. § 469 is going to have under the 3.8 percent tax system are not

encouraging in terms of assuming that I.R.C. § 469(h)(3) will be applicable to I.R.C. § 1411.

It may be years before further guidance is available. In the meantime, the question is the degree of risk that is comfortable for the client.

ENDNOTES

¹ I.R.C. § 1411(a), enacted as part of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a)(1), 124 Stat. 129 (2010). See generally Harl, “The Unearned Income Medicare Contribution (3.8 Percent tax) for Pass-Through Entities (S Corporations and Partnerships: A Red Flag,” 25 *Agric. L. Dig.* 49 (2014); Harl, “Final Regulations Under the Additional Hospital Insurance Tax (0.9 Percent) and the Unearned Medicare Contribution (3.8 Percent),” 24 *Agric. L. Dig.* 187 (2013); Harl, “Proposed Regulations for the Unearned Income Medicare Tax,” 24 *Agric. L. Dig.* 1 (2012).

² I.R.C. § 1411(b).

³ I.R.C. § 1411(c)(1)(A)(i).

⁴ *Id.*

⁵ I.R.C. § 2032A(b)(1)(c)(ii).

⁶ See note 1 *supra*.

⁷ NPRM REG 130507, December 5, 2012, published as Prop. Treas. Reg. §§ 1.1411-0 through 1.1411-10, and Prop. Treas. Reg. § 1.469-0 and 1.469-11.

⁸ T.D. 9644, November 26, 2013, 2013-2 C.B. 676.

⁹ See note 1 *supra*.

¹⁰ See T.D. 9644, Paragraph II(5)(A).

¹¹ See T.D. 9644, Paragraph II(5)(E)(iii).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

PREFERENTIAL TRANSFERS. The debtor was a grain storage facility owned and operated by an individual. The individual also operated a farm and had filed for bankruptcy. In the several years prior to the debtor's filing for bankruptcy, the debtor had transactions with several farmers for crops stored in the debtor's facility before and after sale to third parties. The transactions had a history of payment over the few months after delivery of the crop. The debtor also sold farm supplies to the farmers and often settled all accounts at the end of each calendar

year. That pattern was continued during the year prior to the filing for bankruptcy and the trustee sought to recover the payments made in the last year as preferential transfers. The debtor argued that the transfers were not voidable because they were made within the ordinary course of business. The court also found that the testimony and evidence supported a finding that the farm actually was still owed money from the past year's transactions, even though the farmer had not filed a claim in the bankruptcy case. The debtor had included the farmer as a creditor. Therefore, the court held that the payments to the farmer by the debtor in the year before the bankruptcy filing were not preferential transfers because they were made in the ordinary course of business and the creditor did not receive more than what would be received in a Chapter 7 case. *In re Tanglewood Farms, Inc., 2014 Bankr. LEXIS 2288 (Bankr. E.D. N.C. 2014).*