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The Unearned Income Medicare Contribution (3.8 Percent Tax) for Pass-Through Entities (S Corporations and Partnerships): A Red Flag

-by Neil E. Harl*

On November 26, 2013, the Department of the Treasury issued final regulations for the Unearned Income Medicare Contribution,¹ the 3.8 percent tax,² which was enacted as part of the Patient Protection and Affordable Care Act.³ Although the statute provided a framework for imposition of the 3.8 percent tax on the disposition of interests in pass-through entities (such as S corporations, general partnerships, limited partnerships, limited liability companies and limited liability partnerships) the rules were not abundantly clear even after the regulations were issued. In this article, we endeavor to provide some insight into how the 3.8 percent tax is imposed and some of the traps apparently involved.

Guidance from the statute

The statute⁴ states that the 3.8 percent tax is imposed on “net investment income”⁵ which is defined as interest, dividends, annuities, royalties, and rents” other than “. . . income derived in the ordinary course of a trade or business. . . .”⁶ The statute goes on to state that “net investment income” also includes “. . . gross income derived from a trade or business. . . .” and “. . . net gain (to the extent taken into account in computing taxable income) attributable to the disposition of other than property held in a trade or business...” to the extent the trade or business is a passive activity⁷ or involves trading in financial instruments or commodities.⁸ Note carefully the two areas of economic activity that can result in inclusion in net investment income for a pass-through entity – (1) if the entity is a passive activity under the requirements of I.R.C. § 469, or (2) it is trading in financial instruments or commodities.⁹ Also, note carefully the reference to “commodities” as that term is defined and which is discussed below.¹⁰

Insight from the regulations

The final regulations provide some additional insight under the heading of “Definition of Investment Income.”¹¹ That passage forthrightly states that gross income is excluded from net investment income if it is derived in the ordinary course of a trade or business *not described in Treas. Reg. § 1.1411-5*. That key provision lists two fact situations.

- One involves an individual owning an interest in a pass-through entity, such as an S corporation or an entity taxed as a partnership (for example, a limited liability company (LLC)), where that individual is “engaged in a trade or business.” That determination is made *at the owner level*, which apparently means that if one or more of the owners is engaged in the business on a passive basis, that portion of gross income is not excluded from “net investment income.”¹²

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EXAMPLE 1: three brothers, John, Frank and Tom own all of the stock of their S corporation which was inherited from their parents. John and Frank operate the farm; Tom is employed in another state and has no involvement with the farm other than being a passive owner. Tom's share of the income would be subject to the 3.8 percent tax; the income attributable to John and Frank would be excluded from the 3.8 percent tax.

EXAMPLE 2: the same facts except that Tom is also involved in the farming operation, as fully as John and Frank. All of the income should be excluded from the 3.8 percent tax.

- The other fact situation involves trading in financial instruments or commodities. However, this determination is apparently made at the *entity level, not at the owner level*.¹³

EXAMPLE 3: Joe, Sam and Leo are three brothers who together own an LLC which operates a large grain farm. The LLC routinely hedges its commodities and occasionally speculates on various commodities. Because the determination is made at the entity level, none of the income would appear to be excluded from "net investment income" except, perhaps, to the extent the activity (such as hedging) is derived in the ordinary course of the trade or business.

Meaning of "trading in . . . commodities"

Obviously, the definition of "commodities" is important in many farming and ranching situations. The statute¹⁵ refers to I.R.C. § 475(e)(2) for the meaning of "commodities."¹⁶ That subsection defines "commodity" as "any commodity which is personal property and which is actively traded" and includes derivatives of the commodity and specifically includes "any option, forward contract, futures contract, short position and any similar instrument."¹⁷ In addition, the term "commodity" includes "hedges" with respect to a commodity.¹⁸ That means, surprisingly, that essentially all futures contracts are considered potentially subject to the rule barring exclusion from "net investment income."

Remember, the determination of any provisions referring to "a trade or business of trading in financial instruments or commodities" is made at the entity level, not at the owner level.¹⁹ Presumably "entity level" means if the entity is so engaged, all income is potentially barred from exclusion from "net investment income." But does it also mean if any owner is engaged in such activity the entity is deemed also to be so engaged because the determination is made at the entity level? That is not clear but it would seem that for commodities and for trading in financial instruments, the focus is only at the entity level.

One possible solution

This development adds another reason for eligible entities to consider utilizing the "small partnership" exception where eligible entities are not considered to be a partnership for federal income tax purposes.¹⁹

ENDNOTES

¹ T.D. 9644, 2013-2 C.B. 676; 78 Fed. Reg. 72393 (Dec. 2, 2013).

² I.R.C. § 1411(b).

³ Pub. L. No. 111-148, 124 Stat. 119 (2010). See the Health

Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

⁴ I.R.C. § 1411(c).

⁵ I.R.C. § 1411(c)(1).

⁶ I.R.C. § 1411(c)(1)(A)(i).

⁷ I.R.C. § 469.

⁸ I.R.C. § 1411(c)(2)(A),(B).

⁹ *Id.*

¹⁰ I.R.C. § 1411(c)(2)(B).

¹¹ Treas. Reg. § 1.1411-4.

¹² Treas. Reg. § 1.1411-5(a)(1).

¹³ Treas. Reg. § 1.1411-5(a)(2).

¹⁴ I.R.C. § 1411(c)(2)(B).

¹⁵ I.R.C. § 1411(c)(2)(B).

¹⁶ I.R.C. § 1411(c)(2)(B).

¹⁷ I.R.C. § 475(e)(2)(C).

¹⁸ I.R.C. § 475(e)(2)(D)(ii).

¹⁹ Treas. Reg. § 1.1411-5(a)(2).

²⁰ I.R.C. § 6231(a)(1)(B); IRS Manual 20.1.2.3.3.1. See Harl, "The 'Small Partnership' Exception: A Way to Escape Partnership Tax Complexities," 23 *Agric. L. Dig.* 1 (2012).

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