



Estates and Trusts: The New 3.8% Medicare Tax on Net Investment Income

A Wealth Planning Advisory Services Publication

Effective January 1, 2013 estates and trusts will be subject to the new 3.8% Medicare Contribution Tax on net investment income. The Internal Revenue Service has issued proposed regulations that provide helpful interim guidance regarding the implementation of the tax with respect to estates, trusts and beneficiaries until final regulations are promulgated.

Application to Estates and Trusts

Author,
Suzanne L. Shier,
Director of
Wealth
Planning and
Tax Strategy

Under Internal Revenue Code (Code) section 1411, the 3.8% Medicare Contribution Tax will be imposed on the lesser of (i) an estate or trust's undistributed net investment income or (ii) the excess (if any) of the estate or trust's adjusted gross income over the dollar amount at which the highest income tax bracket begins in the taxable year. In 2013, the highest inflation adjusted income tax bracket for an estate or trust is expected to begin at \$11,950.

The threshold for application of the section 1411 tax on an estate or trust with undistributed net investment income is much lower than the applicable thresholds for individuals (\$250,000 for a married couple filing jointly or a surviving spouse, \$125,000 for a married taxpayer filing separately, and \$200,000 for all others). Although the threshold for an estate or trust is relatively low, it is helpful to know that the full threshold amount generally will apply (without prorating) even in short tax years.

December 14,
2012

Net Investment Income and Undistributed Net Investment Income

Piecing the section 1411 puzzle together for estates and trusts requires computation of "net investment income" (NII) and "undistributed net investment income" (UNII), taking into account both the allocation of net investment income between an estate or trust and beneficiaries as well as the character of the income. In order to maintain consistency, the proposed regulations allocate net investment income between an estate or trust and beneficiaries and also categorize types of income for purposes of the section 1411 tax in a manner based upon that used for purposes of income taxation generally.

Recall that in the case of U.S. domestic estates and nongrantor trusts, in order to appropriately allocate the incidence of income tax between an estate or trust and its beneficiaries, the Code provides for a deduction of distributions to beneficiaries in computing taxable income at the estate or trust level. The amount deducted in computing the taxable income of the estate or trust is included in the computation of the taxable income of the beneficiaries. The character of the income earned at the estate or trust level is preserved at the beneficiary level for U.S. beneficiaries of domestic trusts.

Similarly, in the case of the section 1411 tax, "undistributed net investment income" (a term used solely for the determination of the section 1411 tax for estates and trusts) taxed to the



trust is defined as net investment income reduced by (i) the share of net investment income included in the beneficiary distribution deduction of the estate or trust, and (ii) the charitable deduction for amounts paid or permanently set aside for charitable purposes. In effect, as is the case for purposes of the computation of the taxable income of an estate or trust for income tax purposes generally, an estate or trust is treated as a conduit of net investment income to the beneficiary and it is only that portion of net investment income that is trapped at the estate or trust level that is treated as undistributed net investment income and taxed to the estate or trust.

The starting point is the computation of net investment income, which is the same for individuals, estates and trusts. For purposes of the section 1411 tax, net investment income is the excess (if any) of –

- the sum of—
 - gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply,
 - other gross income from trades or businesses to which the tax applies, and
 - net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply, over
- allowable deductions properly allocable to such gross income or net gain.

This general definition of net investment income as further clarified in the proposed regulations provides for included income and, by omission, excluded income for purposes of the section 1411 tax. When applied to estates and trusts, the proposed regulations adopt the class system of categorization of income used in the computation of distributable net income (DNI) for income tax purposes to arrive at a trust's net investment income reduction where a beneficiary distribution is comprised of both included and excluded items of income. Thus, as discussed in greater detail below, in addition to keeping record of trust accounting income and distributable net income, beginning in 2013 trustees will be required to keep record of net investment income accumulated by a trust and net investment income distributed to a beneficiary, taking the character of the income into account.

Trusts Subject to the Section 1411 Tax

The section 1411 tax generally applies to “ordinary trusts.” Specifically excluded are business trusts treated as business entities and certain trusts created under state statutes that are subject to special tax treatment under the Code, such as common trust funds taxed under Code Section 584. In addition, the section 1411 tax does not apply to trusts or funds that are exempt from income tax, even if they may be subject to the special tax on unrelated business income under Code section 511. Examples are 529 accounts and charitable remainder trusts (although special tax accounting discussed below will be required for charitable remainder trusts). In the case of a grantor trust treated as owned by the grantor or another person under Code sections 671 through 679 (a “grantor trust”), the section 1411 tax will not apply to the trust itself. Rather, the income of the trust will be treated as being the income of the grantor or other owner for purposes of the section 1411 tax.



Type of Trust	Section 1411 Taxation
Business trust treated as business entity	Not applicable
Common trust funds taxed under section 584	Not applicable
Designated settlement funds taxed under section 468B(b)(4)	Not applicable
Pooled income funds described in Section 642(c)(5)	Applies
Cemetery perpetual care funds described in Section 642(i)	Applies
Qualified funeral trust described in Section 685	Applies
Alaska Native settlement trust described in Section 685	Applies
Tax-exempt fund or trust (e.g., charitable remainder trust, Archer MSA, health savings account, 529 qualified tuition program, Cloverdale education savings account)	Not applicable even if fund or trust subject to section 511 tax on unrelated business taxable income, but computation of NII portion of annuity or unitrust distribution from charitable remainder trust required
Trusts with unexpired interests for charitable purposes (e.g., charitable lead trusts)	Not applicable
Grantor trusts under sections 671-679	Not applicable to trust; NII of grantor or other owner for section 1411 tax
Electing small business trust	Applies; special rules to determine section 1411 tax base
Foreign estate and foreign nongrantor trust	Should not apply if little or no connection to U.S.; potential application if U.S. beneficiary
Bankruptcy estate of individual debtor	Applies to debtor using deemed married filing separately status for threshold amount

Charitable Remainder Trusts

Although a charitable remainder trust is not subject to the section 1411 tax at the trust level, the proposed regulations provide computational rules to track annuity and unitrust distributions that constitute net investment income to the non-charitable beneficiary during the annuity or unitrust term.

Annuity and unitrust distributions from a charitable remainder trust to non-charitable beneficiaries are ordered for income tax purposes based on what is commonly referred to as a four-tier system (ordinary income, capital gains, tax-exempt income, and principal). However, in the interest of administrative convenience these ordering rules are not applied for purposes of the section 1411 tax. Rather, the proposed regulations provide that annuity and unitrust distributions are treated as including net investment income in an amount equal to the lesser of (i) the total amount of the distributions for the year, or (ii) the current and accumulated net investment income of the charitable remainder trust. Accumulated net investment income is the total amount of net investment income received by a charitable remainder trust for all taxable years after December 31, 2012 less the total amount of net investment income distributed for all prior taxable years that begin after December 31, 2012. Again, although a charitable remainder trust itself will not be subject to the section 1411 tax,



additional recordkeeping will be required by the trustee for purposes of the tax reporting required with respect to the distributions to beneficiaries. If a trust has multiple annuity or unitrust beneficiaries, the net investment income will be apportioned among the beneficiaries based on the respective shares of the total annuity or unitrust they are paid by the trust in a taxable year.

Foreign Estates and Trusts

Foreign estates and foreign trusts with little or no connection to the United States are not subject to the section 1411 tax. However, the tax will apply to the extent that income of a foreign nongrantor trust is earned or accumulated for the benefit of, or distributed to, U.S. persons. For foreign grantor trusts, the section 1411 tax applies to the U.S. grantor or other U.S. owner.

An Example of the Computation

The complexity of the application of the section 1411 tax to estates and trusts is demonstrated by even the least complex example included in the proposed regulations. Following is one of the examples:

In Year 1, Trust has dividend income of \$15,000, interest income of \$10,000, capital gain of \$5,000, and \$60,000 of taxable income relating to a distribution from an individual retirement account. Trust has no expenses. Trust distributes \$10,000 of its current year trust accounting income to A, a beneficiary of Trust. For trust accounting purposes, \$25,000 of the distribution from the individual retirement account is attributable to income. Trust allocates the remaining \$35,000 of taxable income from the individual retirement account and the \$5,000 of capital gain to principal, and therefore these amounts do not enter into the calculation of Trust's distributable net income for Year 1.

Trust's distributable net income is \$50,000 (\$15,000 in dividends plus \$10,000 in interest plus \$25,000 of taxable income from an individual retirement account), from which the \$10,000 distribution to A is paid. Trust's deduction is \$10,000. The deduction reduces each class of income comprising distributable net income on a proportional basis. The \$10,000 distribution equals 20 percent of distributable net income (\$10,000 divided by \$50,000). Therefore, the distribution consists of dividend income of \$3,000, interest income of \$2,000, and ordinary income attributable to the individual retirement account of \$5,000. Because the \$5,000 of capital gain allocated to principal for trust accounting purposes did not enter into distributable net income, no portion of that amount is included in the \$10,000 distribution, nor does it qualify for the deduction.

Trust's net investment income is \$30,000 (\$15,000 in dividends plus \$10,000 in interest plus \$5,000 in capital gain). Trust's \$60,000 of taxable income attributable to the individual retirement account is excluded income (within the meaning of the proposals) because it is excluded from net investment income. Trust's undistributed net investment income is \$25,000, which is Trust's net investment income (\$30,000) less the amount of dividend income (\$3,000) and interest income (\$2,000) distributed to A. The \$25,000 of undistributed net investment income is comprised of the capital gain allocated to principal (\$5,000), the remaining undistributed dividend income



(\$12,000), and the remaining undistributed interest income (\$8,000).

Under the proposed regulations, A's net investment income includes dividend income of \$3,000 and interest income of \$2,000, but does not include the \$5,000 of ordinary income attributable to the individual retirement account because it is excluded from net investment income.

	Trust Receipts	Trust Accounting Income	Trust's DNI	A's Distribution and Trust's Distribution Deduction	Trust's Total NII	A's Share NII	Trust's UNII
Dividends	\$15,000	\$15,000	\$15,000	\$3,000	\$15,000	\$3,000	\$12,000
Taxable Interest	\$10,000	\$10,000	\$10,000	\$2,000	\$10,000	\$2,000	\$8,000
Capital Gain	\$5,000	--	--	--	\$5,000	--	\$5,000
IRA Distribution	\$60,000	\$25,000	\$25,000	\$5,000	--	--	--
Total	\$90,000	\$50,000	\$50,000	\$10,000	\$30,000	\$5,000	\$25,000
Percentage of DNI				20%			

Effective Dates of the Proposed Regulations

Although the section 1411 tax will be in effect in 2013, the regulations generally are proposed to be effective for taxable years beginning *after* December 31, 2013. However, taxpayers may rely on the proposed regulations until final regulations are effective. Note that the Service has "reserved" a number of areas of specific guidance and is seeking comments.

Looking Ahead to 2013 and Beyond

Trustees face new administrative challenges tracking and calculating the new 3.8% Medicare Contribution Tax as it applies to estates and trusts. The proposed regulations provide helpful guidance and further refinements are expected when final regulations are issued.

(c) 2012, Northern Trust Corporation. All rights reserved. Northern Trust Wealth Planning Advisory Services includes Family Education and Governance, Philanthropy, Wealth Transfer, Tax Strategy and Financial Consulting.

LEGAL, INVESTMENT AND TAX NOTICE: This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own counsel.

IRS CIRCULAR 230 NOTICE: To the extent that this outline or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. For more information about this notice, see <http://www.northerntrust.com/circular230>.

