3.8% Medicare Tax on Net Investment Income

Capital Losses and Calculation Net Investment Income

Beginning in 2013, a new 3.8% Medicare surtax is imposed on a taxpayer's "net investment income". Net investment income is 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 derived from a trade or business to which the tax applies (passive activities), 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
- The deductions which are properly allocable to such gross income or net gain.

A question was raised in the Update seminars as to how capital losses calculated for income taxes under IRC § 1211(b) will reduce or adjust the calculation of net gain as a part of net investment income for the new Medicare tax. The answer can be found in the examples in the proposed regulations released in December 2012 [Prop Reg § 1.1411-4(g)].

Example 1

In **Year 1**, Paul, an unmarried individual, realizes a capital loss of $ 40,000 on the sale of ABC stock and realizes a capital gain of $ 10,000 on DEF stock, resulting in a net capital loss of $ 30,000. Both ABC and DEF are C corporations. Paul has no other capital gains or capital losses in Year 1. In addition, Paul receives wages of $ 300,000 and earns $ 5,000 of interest income. For income tax purposes, Paul may deduct a $ 3,000 net capital loss under IRC § 1211(b), and under IRC § 1211(b)(1), the remaining $ 27,000 is a capital loss carryover. For purposes of the calculation of net investment income, the $ 10,000 capital gain is offset by the capital loss, but not less than zero. Paul may not reduce net investment income by the $ 3,000 capital loss allowed for income tax purposes.

In **Year 2**, Paul has a capital gain of $ 30,000 on the sale of GHI stock, a C corporation. Paul has no other capital gains or capital losses in Year 2. For income tax purposes, Paul may reduce the $ 30,000 gain by the $ 27,000 capital loss carryover from Year 1. For purposes of determining Paul's Year 2 net investment income, the $ 30,000 gain may also be reduced by the

$ 27,000 capital loss carryover from Year 1 resulting in $ 3,000 of capital gain included in Year 2 net investment income.

Example 2

The facts are the same as in Example 1, except that in Year 1, Paul also realizes a gain of $ 20,000 on the sale of Rental Property D, all of which is treated as ordinary income under IRC § 1250. For income tax purposes, Paul may use $ 3,000 of the net capital loss against other income. The $ 27,000 is a capital loss carryover. For purposes of determining Paul's net investment income, the gain on the sale of ABC stock is fully offset by the loss on the DEF stock. Paul's $ 20,000 gain on the sale of the Rental Property D **is** reduced by the $ 3,000 capital loss allowed for income tax purposes. Therefore, Paul's net gain for Year 1 is $ 17,000 ($ 20,000 ordinary income on the sale of Rental Property D reduced by $ 3,000 capital loss allowed for income tax purposes).