Chapter 3: Affordable Care Act Update

Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

INDIVIDUAL MANDATE

The following acronyms are used in this section.

- ACA — Affordable Care Act
- CHIP — Children's health insurance program
- HHS — Department of Health and Human Services
- MAGI — Modified adjusted gross income
- MEC — Minimum essential coverage
- PAC — Premium assistance credit
- QHC — Qualified health plan

The Affordable Care Act (ACA) includes an **individual mandate** that imposes requirements on individuals for the maintenance of qualifying health insurance coverage. Effective January 1, 2014, unless an individual is exempt from the individual mandate, the individual must maintain minimum essential coverage (MEC) for themselves and their dependents or pay a penalty.[1] The penalty is assessed on a monthly basis, but an individual is deemed to have MEC for the month if that individual has MEC in place for at least one day of that month.[2]

Observation. Generally, there are three government agencies responsible for the administration of the individual mandate: the IRS, the Department of Health and Human Services (HHS), and the Department of Labor (DOL). Each agency administers their own respective parts of the individual mandate.

1. IRC §5000A(b)(1).
2. Treas. Reg. §1.5000A-1(b)(1).

MINIMUM ESSENTIAL COVERAGE[3]

Generally, health insurance coverage must be comprehensive in order to qualify as MEC. Limited-benefit or limited-purpose coverage does not qualify. MEC includes comprehensive **group coverage** and certain **government plans.**

Group coverage that qualifies as MEC includes the following.

- Employer-sponsored group plan coverage provided to employees
- Government plans established for federal or state employees (including employees of federal or state political subdivisions)
- Grandfathered plans

> **Note.** A grandfathered plan is an employer-sponsored plan that was in place on the date the ACA was enacted (March 23, 2010). It may be offered by the employer as MEC as long as certain recordkeeping and other requirements are met. A grandfathered plan can enroll new employees and still maintain its grandfathered status.[4]

Employer-sponsored plans include group coverage obtained from the Marketplace and self-insured plans offered by the employer to its employees. **Marketplace** is the IRS designation encompassing **all** state and federal health insurance exchanges and is used in this chapter when referring to all state and federal health insurance exchanges.

Government plans that qualify as MEC include the following.[5]

- Medicare
- The Children's Health Insurance Program (CHIP)
- Medicaid

> **Note.** Certain optional programs under Medicaid do not qualify as MEC, such as the optional coverage for family planning services, pregnancy services, or emergency medical services under Medicaid.[6] However, transitional relief is provided for individuals enrolled under these limited optional programs who do not have any other coverage. Under transitional relief, such individuals are not subject to any penalty for failure to maintain MEC for 2014.

- Medical coverage provided to members of the armed forces, including TRICARE coverage, and continuation coverage offered to employees and their dependents after separation from service

> **Note.** Under proposed regulations, there are limited-benefit programs under TRICARE that do not qualify as MEC.[7] For individuals who obtained limited-benefit TRICARE coverage that does not qualify as MEC during the 2014 open enrollment period, the IRS provided transitional relief from any penalties for any month during 2014 in which the individual had such coverage.

- Medical coverage for veterans
- The Peace Corps volunteer health plan

3. Treas. Reg. §1.5000A-2.
4. *Grandfathered Health Insurance Plans*. Healthcare.gov. [www.healthcare.gov/what-if-i-have-a-grandfathered-health-plan/] Accessed on Aug. 14, 2014.
5. IRC §5000A(f)(1)(A).
6. IRS Notice 2014-10, 2014-9 IRB 605; and Treas. Reg. §1.5000A-2(b).
7. Prop. Treas. Reg. §1.5000A-2(b)(2)(vii).

Certain **individual plans** that are not part of a group plan also qualify as MEC. **A plan obtained through a state exchange** (other than a short-term, limited duration plan)[8] **qualifies as MEC.**

Note. Further details about qualifying coverage may be found in Treas. Reg. §1.5000A-2. For further information on transitional relief provisions for 2014, see the notice of proposed rulemaking, REG-141036-13, contained in IRB 2014-7 on page 516 and the related corrections, RIN 1545-BL91, published on June 3, 2014, in the Federal Register, Volume 79, Number 106, page 31893.

EXEMPTIONS FROM THE INDIVIDUAL MANDATE

Under the ACA, there are a total of **nine** exemptions from the individual mandate. These are administered by the state exchanges, by the IRS, and some are administered by either the state exchange or the IRS.[9] The nine exemptions are summarized in the following table.

		Administration	
Exemption	**Code Reference**	**IRS**	**Exchange**
Affordable coverage unavailable	IRC §5000A(e)(1)	X	
Income below filing threshold	IRC §5000A(e)(2)	X	
Indian tribe members	IRC §5000A(e)(3)	X	X
Short-coverage gap period	IRC §5000A(e)(4)	X	
Hardship	IRC §5000A(e)(5)	[a]	[a]
Religious objection	IRC §5000A(d)(2)(A)		X
Health care sharing ministry	IRC §5000A(d)(2)(B)	X	X
Nonresident alien, undocumented alien residents	IRC §5000A(d)(3)	X	
Incarcerated individuals	IRC §5000A(d)(4)	X	X

[a] Depends on grounds.

The following section provides details about four of the nine exemptions.

1. Affordable coverage unavailable
2. Income below filing threshold
3. Hardship
4. Short-coverage gap period

Note. Details about the other exemptions may be found in the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Healthcare Reform Act. This can be found at **www.taxschool.illinois.edu/taxbookarchive.** Details can also be found in the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update. In addition, final rules regarding the exemptions may be found in Treas. Reg. §1.5000A-3 and 45 CFR §155.605.

8. IRC §5000A(f)(1)(C); and Treas. Reg. §1.5000A-2(d).
9. 45 CFR §155.605.

1. Affordable Coverage Unavailable Exemption

Claiming the Exemption. The **affordable coverage unavailable exemption** is claimed only by filing a tax return and is administered by the IRS.[10] Form 8965, *Health Coverage Exemptions,* which follows, is used to report the 2014 health coverage exemptions.

> **Observation.** Whether a taxpayer is eligible for this exemption for a particular tax year depends on the amount of annual household income. Because this exemption is claimed by filing a tax return, it must be claimed **after the end of the tax year** for which it applies. At the beginning of the tax year, taxpayers may be uncertain whether their household income will be low enough for them to qualify for this exemption. Although commentators expressed concern about the proposed regulations, the IRS decided to keep the procedure for this exemption intact.[11] The taxpayer has the option of claiming the **lack of affordable coverage hardship exemption** (discussed later), which is based on **projected** income.

> **Note.** Among the various hardship exemptions (discussed later in this section) there is one for **lack of affordable coverage.** That exemption should not be confused with the **affordable coverage unavailable** exemption.

10. CMS-9958-F, Federal Register, Vol. 78, No. 126.

11. CMS-9958-F, Federal Register, Vol. 78, No. 126.

Form **8965**

Department of the Treasury
Internal Revenue Service

Health Coverage Exemptions

▶ Attach to Form 1040, Form 1040A, or Form 1040EZ.
▶ **Information about Form 8965 and its separate instructions is at *www.irs.gov/form8965*.**

OMB No. 1545-0074

2014

Attachment Sequence No. **75**

Name as shown on return	Your social security number

3

Complete this form if you have a Marketplace-granted coverage exemption or you are claiming a coverage exemption on your return.

Part I **Marketplace-Granted Coverage Exemptions for Individuals:** If you and/or a member of your tax household have an exemption granted by the Marketplace, complete Part I.

	a Name of Individual	b SSN	c Exemption Certificate Number
1			
2			
3			
4			
5			
6			

Part II **Coverage Exemptions for Your Household Claimed on Your Return:**

7a Are you claiming an exemption because your household income is below the filing threshold? . . . . . . ☐ **Yes** ☐ **No**

b Are you claiming a hardship exemption because your gross income is below the filing threshold? . . . . . ☐ **Yes** ☐ **No**

Part III **Coverage Exemptions for Individuals Claimed on Your Return:** If you and/or a member of your tax household are claiming an exemption on your return, complete Part III.

	a Name of Individual	b SSN	c Exemption Type	d Full Year	e Jan	f Feb	g Mar	h Apr	i May	j June	k July	l Aug	m Sept	n Oct	o Nov	p Dec
8																
9																
10																
11																
12																
13																

For Privacy Act and Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37787G Form **8965** (2014)

For 2014, affordable coverage is **not available** if the individual must pay **more than 8%** of their household income for health insurance coverage.[12] After 2014, the percentage rate is adjusted by HHS to reflect differences between premium growth and income growth for the year. For 2015, the rate is 8.05%.[13]

Household income is defined as the:

- Taxpayer's modified adjusted gross income (MAGI), plus
- The MAGI of the taxpayer's **family members** who are **required to file a federal tax return** for the year. Family members are those for whom the taxpayer **properly claims an exemption for the year.**[14]

> **Observation.** This exemption is not the only area where the concept of household income is used. It is also used for penalty calculations.

MAGI. MAGI is a taxpayer's adjusted gross income (AGI) plus the amount, if any, of **tax-exempt interest** received (or accrued) during the year, plus any amounts excluded from AGI under the **foreign earned income or foreign housing cost** provisions of IRC §911.

In addition, if the taxpayer pays for health coverage through an employer using a salary reduction arrangement and the payment amounts are excluded from the taxpayer's gross income for the year, the taxpayer's MAGI must be increased by the amount of those payments.[15]

Family Members. The Code includes anyone whom the taxpayer is allowed to claim as a dependent in the definition of family.[16] To determine the household income of a taxpayer, **family members** may include the taxpayer, the taxpayer's spouse when the couple files jointly, and the dependents claimed on the taxpayer's tax return. However, if any of these people are not required to file a return, their income is **not** included in household income.[17]

> **Note.** Presumably, the taxpayer must still include the income of any person who **could be** legally claimed as a dependent even if the taxpayer does not claim them.

Generally, a dependent must file a return if their income is in excess of the standard deduction. The standard deduction for dependents is determined by the type of income received by the dependent.[18] For these purposes, income is classified as earned and unearned. For 2014, the relevant standard deduction amounts, which serve as the filing thresholds for dependents, the greater of:[19]

- $1,000 or
- The dependent's earned income plus $350 (up to $6,200)

> **Note.** For additional information on the filing requirements for dependents, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers.

12. IRC §5000A(e)(1)(A).
13. *Patient Protection and Affordable Care Act; Exchange and Insurance Market Standards for 2015 and Beyond.* May 27, 2014. The Federal Register. [www.federalregister.gov/articles/2014/05/27/2014-11657/patient-protection-and-affordable-care-act-exchange-and-insurance-market-standards-for-2015-and#h-8] Accessed on Jun. 28, 2014.
14. Treas. Reg. §1.5000A-1(d)(4).
15. Treas. Reg. §1.5000A-3(e)(1).
16. IRC §5000A(c)(4)(A).
17. Treas. Reg. §1.5000A-1(d)(10)(i)(B).
18. IRC §63(c)(5).
19. 2014 Form 1040-ES, *Estimated Tax for Individuals*.

If a parent makes the election to include a child's unearned income on the parent's return, this amount counts as the parent's income when calculating household income.[20]

Cost of Health Insurance Coverage. The out-of-pocket cost of health insurance coverage is referred to as the **required contribution.** To determine whether the cost of the health insurance is too high to be considered affordable, the cost is calculated based on whether the person is eligible for coverage under an employer-sponsored plan or if the person must look to the Marketplace to obtain coverage.

Employer-Sponsored Coverage Available.[21] If a person is eligible for employer-sponsored coverage, the cost of health insurance coverage is determined based on the employer's plan.[22] For the employee, the required contribution is that part of the cost for coverage that the employee would be obligated to pay for the lowest-cost self-only coverage available through the employer plan.[23] For 2014, if the employee's cost is **greater than 8%** of the employee's household income, the individual is considered exempt because they do not have access to affordable coverage.

Individuals who are eligible to enroll in employer-sponsored coverage because they are related to an employee **must** also use the employer's plan to determine the cost of health insurance coverage available to them. This **only applies** if the individual **files jointly** with the employee or **is claimed as** a dependent by the employee.

Whether the taxpayer and related individuals are eligible for employer coverage is determined on a month-to-month basis. The taxpayer and all related individuals are deemed eligible for employer-sponsored coverage for a month during the year if they could have enrolled in the employer-sponsored plan for any day during that month (regardless of whether they are also eligible for MEC from another source).

The cost of health insurance for members of the employee's family is the amount that the employee would pay for the **lowest-cost family coverage** under the employer's plan that would cover the employee and all related individuals who do not fall under another exemption.

> **Observation.** There are only four simple examples provided in Treas. Reg. §1.5000A-3(e)(3) to illustrate the application of the various rules used to calculated the cost of insurance under employer-provided plans. This has created uncertainty about application of the rules.

Former employees and their families only use the employer-provided plans to determine their cost if they actually enroll in retiree coverage or in some type of continuation coverage (such as under COBRA) for which they are eligible under federal or state law.

> **Note.** The **Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)**[24] provides certain employees and their families with a legal right to obtain temporary coverage to replace coverage that existed through an employer if a qualifying event takes place. A **qualifying event** includes voluntary or involuntary termination of employment, a reduction of hours that makes the employee ineligible under the employer's health plan, death, divorce, or other life events. Further information on COBRA coverage may be found on the DOL website at **www.dol.gov/dol/topic/health-plans/cobra.htm.**

20. TD 9632, 2013-39 IRB 241.
21. Treas. Reg. §1.5000A-3(e)(3).
22. Ibid.
23. IRC §5000A(e)(1)(B)(i); and Treas. Reg. §1.5000A-3(e)(3)(ii)(A).
24. PL 99-272.

Example 1. Sonia is a single individual with no dependents. She works as a store manager for Lost City Department Stores (Lost City). She earns $45,000 per year. The following amounts are relevant for the 2014 tax year for Sonia.

Sonia's 2014 household income	$45,000
8% of Sonia's 2014 household income	3,600
Lowest-cost self-only coverage option available through Lost City health plan	4,300

Because Sonia's 2014 required contribution of $4,300 is greater than 8% of her 2014 household income ($3,600), she does not have **affordable coverage available.** She is **exempt from the individual mandate for 2014.** If she does not have coverage during 2014, she is not liable for any related penalty in 2014.

Example 2. Tex and Frieda are married and have two children, Ryan and Rianna. Ryan and Rianna are 14 and 12 years of age, respectively. Tex is employed full-time as a logistics manager for a trucking company, Road7 Shipping, Inc. (Road7).

Tex earns a salary of $50,000 in 2014. Frieda works part-time as a legal secretary at a local law firm that does not offer an employee health plan. Her 2014 salary is $28,000. In 2014, she receives $3,000 of tax-exempt interest. Tex and Frieda file jointly for 2014 and claim personal exemptions for themselves and two dependent exemptions for Ryan and Rianna.

Tex can obtain coverage for himself through Road7. The lowest-cost self-only plan Tex can obtain through the Road7 health plan would cost $3,400.

Tex could also obtain coverage for Frieda, Ryan, and Rianna under one of the family coverage plans offered by Road7. The lowest-cost family coverage costs Tex $6,600 to have the three family members covered.

The family's 2014 household income is as follows.

Tex's salary	$50,000
Frieda's salary	28,000
Frieda's tax-exempt income	3,000
Total household income	$81,000

For 2014, 8% of the family's household income is $6,480 (8% × $81,000). Because Tex's $3,400 required contribution is **less than 8%** of household income, Tex has **affordable coverage available** and is **not exempt** from the individual mandate for 2014.

Frieda, Ryan, and Rianna have a required contribution of $6,600. Because this required contribution is more than 8% of household income, Frieda, Ryan, and Rianna **do not have affordable coverage available** to them. They are **exempt** from the individual mandate for 2014.

Observation. Tex's required contribution and that for his three family members are compared separately when using the 8%-of-household-income test. Frieda, Ryan, and Rianna base the cost of health coverage for themselves on Tex's employer's plan because they can obtain coverage through his employer, and because Tex claims exemptions for each of them.[25]

25. Treas. Reg. §1.5000A-3(e)(3)(ii)(B).

Example 3. Use the same facts as **Example 2,** except Tex and Frieda's son Ryan is 17 and has a part-time job as a landscaper. His 2014 wages are $7,000. This is Ryan's only 2014 income. Ryan's employer does not provide health insurance. Household income for 2014 is calculated as follows.

Tex's salary	$50,000
Frieda's salary	28,000
Frieda's tax-exempt income	3,000
Ryan's wages	7,000
Total household income	$88,000

Ryan's income is included in the household income because he is required to file a tax return. His $7,000 earned income exceeds his dependent standard deduction of $6,200.

The lowest-cost family coverage plan offered through Tex's employer is $6,600 for 2014. However, **8% of their household income is $7,040** (8% × $88,000). Therefore, Frieda, Ryan, and Rianna have **affordable coverage available** to them and are **not exempt** from the individual mandate. Tex is **not exempt** either because the cost of self-only coverage is $3,400, which is less than 8% of household income.

Example 4. Use the same facts as **Example 3,** except Ryan's 2014 wages are $6,000. This amount is less than the dependent standard deduction of $6,200. Therefore, Ryan is not required to file a 2014 tax return. Because Ryan is not required to file a 2014 tax return, his income is omitted from the calculation to determine the amount of household income.[26]

Consequently, the 2014 household income is $81,000 and the conclusions are the same as in **Example 2.**

Observation. A dependent child's income may be the determining factor when calculating whether affordable coverage is available.

The cost of health insurance is determined separately for each family member who can obtain coverage through their own employer.[27] This may result in each family member having affordable coverage through their respective employer (because each individual can obtain coverage at a cost **less** than 8% of household income). However, the overall combined cost could equal **more** than 8% of household income. If this occurs, regulations permit use of one of the hardship exemptions (discussed later).

Individuals Not Eligible for Employer-Sponsored Coverage.[28] Not all individuals have the option to enroll in employer-sponsored health plans. Accordingly, the cost of health insurance coverage for these individuals is based on the Marketplace that serves the area where they reside.

The health insurance cost for an individual without an available employer-sponsored plan is calculated as:

1. The cost of the single lowest-cost bronze plan available from the Marketplace that covers their entire family, **less**
2. The premium assistance credit (PAC).

Family **does not include** those who are exempt from the individual mandate under other provisions, and it does not include those who are eligible for their own employer-sponsored coverage.

Note. The cost of the applicable Marketplace plan must take into account rating factors such as age or tobacco use.

26. Treas. Reg. §1.5000A-1(d)(10)(i)(B)(2).
27. Treas. Reg. §1.5000A-3(e)(3)(i)(B).
28. Treas. Reg. §1.5000A-3(e)(4).

Example 5. Rebecca is a single taxpayer with no dependents. Her 2014 household income is $35,594. She is self-employed and **not** eligible to enroll in an employer-sponsored health plan. The annual premium for the **lowest-cost self-only bronze plan** available from the Marketplace in her area is $4,700. She qualified for a PAC of $1,619 when she obtained insurance through the Marketplace.

Rebecca's 2014 health insurance cost is the annual premium for the lowest-cost self-only bronze plan that she can obtain through the Marketplace minus her PAC. Her required contribution is $3,081 ($4,700 − $1,619).

Because her required contribution of $3,081 is more than 8% of her household income, or $2,848 ($35,594 × 8%), she **does not have affordable coverage available** in 2014. Consequently, she is exempt from the individual mandate to maintain MEC for 2014 and is not subject to any penalty for not obtaining coverage.

Note. For further details on the PAC, including information on advanced PACs and the PAC reconciliation, see the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Health Care Reform Act. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Note. The preceding five examples assume that the taxpayer's eligibility to obtain coverage through an employer-sponsored plan does not change during the tax year. If there is a change, the calculations must be made on a month-to-month basis for each period. In addition, each employment period that is less than a calendar year, or parts of an employer's plan year that are in different tax years, must use separate affordability determinations. For further guidance on how the calculations for affordability are made for part-year situations, see Treas. Reg. §1.5000A-3(e)(3)(ii)(C).

Under final regulations, if the Marketplace for the area in which the taxpayer resides does not offer a bronze plan that covers the taxpayer and taxpayer's family, then the applicable plan cost is the aggregate costs of the lowest-cost bronze plans available that would collectively cover all nonexempt family members. This rule is useful for a taxpayer with family members living in areas outside the area serviced by one exchange.[29] The proposed regulations originally provided for a simplified method to determine the premium in the event that the exchange area in which the taxpayer resides did not have a single bronze plan that would cover the entire nonexempt family.[30] However, the final regulations did **not** include such an election but did leave open the possibility for one at a later time.[31]

2. Income Below the Filing Threshold Exemption

An individual is exempt from the individual mandate for any tax year in which their household income is below the applicable filing threshold.[32] The **applicable filing threshold** for most individuals is the applicable exemption plus the standard deduction. For most joint filers, the filing threshold is twice the exemption plus the standard deduction.[33] For MFS filers, the threshold is the exemption only.

29. Treas. Reg. §1.5000A-3(e)(4)(ii)(B)(2).
30. TD 9632, 2013-39 IRB 241.
31. Treas. Reg. §1.5000A-3(e)(4)(ii)(B)(2)(ii).
32. Treas. Reg. §1.5000A-3(f).
33. IRC §6012(a)(1)(A)(iv).

The filing thresholds for the **2014 tax year** are as follows.[34]

Filing Status	Filing Threshold Amount	With One Taxpayer Over Age 65 or Blind	With Two Taxpayers Over Age 65 or Blind
Single	$10,150	$11,700	
MFJ	20,300	21,500	$22,700
MFS	3,950	5,150	
HoH	13,050	14,600	
QW	16,350	17,550	

Example 6. Franz and Gretchen are married and both are under age 65 at the end of 2014. Their **2014** household income is $17,750. This is below the **2014** MFJ filing threshold of $20,300. Franz and Gretchen are not required to file a 2014 tax return and are exempt from MEC for 2014.

Example 7. Use the same facts as **Example 6,** except Franz and Gretchen's household income is $26,000 in 2014. They are required to file a 2014 return. They do not meet any of the other exemptions to the individual mandate. They must each have MEC in place in 2014. Otherwise, they are subject to a penalty for each month during 2014 that they do not have MEC.

Final regulations clarify that if the taxpayer properly claims a dependency exemption, the dependent's applicable filing threshold is equal to the filing threshold for the taxpayer who claimed the dependency exemption. This applicable filing threshold and the family's household income are used to determine whether the dependent meets one of the individual mandate exemptions.

Observation. The dependent's own filing threshold cannot be used to determine whether the dependent is exempt. Otherwise, for example, children with no income or income under their filing exemption would automatically be exempt from the individual mandate.

Final regulations clarify that claiming a dependency exemption has no effect on the definition of household income.[35]

Example 8. Use the same facts as **Example 6,** except Franz and Gretchen have a dependent son, Thomas. Thomas had no income in 2014. Franz and Gretchen claims Thomas's exemption and the earned income credit (EIC) for him on their 2014 return. Because their 2014 income is below their filing threshold, they are exempt from the individual mandate in 2014. For purposes of this exemption, Thomas's 2014 filing threshold is considered to be the same as his parents' 2014 MFJ filing threshold of $20,300. **Therefore, Thomas is also exempt from the individual mandate for 2014.**

Example 9. Use the same facts as **Example 8,** except Franz and Gretchen have 2014 household income of $50,000. Because their 2014 household income is over the filing threshold, they must file a 2014 return and are subject to the individual mandate for 2014 (unless they qualify for another exemption).

In addition, Thomas's 2014 filing threshold is the same as his parents. Because their 2014 household income is over the filing threshold, Thomas is also subject to the individual mandate in 2014. Franz and Gretchen are subject to a penalty if they do not have MEC in 2014 for themselves and Thomas.

Note. A taxpayer may have no filing requirement because they have insufficient gross income. Nevertheless, that taxpayer may claim a dependent and file a return in order to obtain a tax benefit such as the EIC. Claiming a dependent who also has income may boost the taxpayer's household income over the filing threshold. Regulations issued by HHS permit the IRS to grant a **hardship exemption** in this circumstance.[36]

34. 2014 Form 1040-ES, *Estimated Tax for Individuals*.

35. TD 9632, 2013-39 IRB 241.

36. 45 CFR §155.605(g)(3).

Claiming the Exemption. A taxpayer does not need to file a tax return in order to claim the exemption. However, if the taxpayer does file a return, this exemption is claimed on the tax return.[37]

Example 10. Use the same facts as **Example 8,** except Franz and Gretchen's income was below the 2014 filing threshold. If they do not file a 2014 return, they are exempt from the individual mandate in 2014. Conversely, if they ultimately decide to file a 2014 return, Franz and Gretchen will use Form 8965 to report the household-income-below-filing-threshold exemption for 2014.

3. Hardship Exemption[38]

There are several definitions of hardship under which the taxpayer may qualify for an exemption from the individual mandate. The taxpayer only needs to meet one of these definitions in order to qualify for the hardship exemption. The Marketplace covering the individual's state of residence is generally responsible for determining whether an individual meets one of these exceptions to the individual mandate.

General Hardship. Any of the following three circumstances qualify under the general definition of hardship.

1. The individual experiences financial or domestic circumstances, including an unexpected natural or human-caused event, that causes a significant and unexpected increase in essential expenses that prevents the individual from obtaining MEC.
2. The expense of obtaining qualified coverage would cause the individual serious deprivation of food, shelter, clothing, or other necessities.
3. The individual experiences other circumstances that preclude them from acquiring MEC.

If the Marketplace finds that that the individual's circumstances qualify under one of these three tests, the Marketplace **must** grant the taxpayer a hardship exemption that covers the number of months in which the hardship exists, plus the month before and the month after such hardship.

The Center for Medicare and Medicaid Services provides guidance on what circumstances may constitute hardship. These apply to individuals in the following circumstances.[39]

- Became homeless
- Was evicted in the past six months, or faces eviction or foreclosure
- Received a shut-off notice from a utility company
- Recently experienced domestic violence
- Recently experienced a death of a close family member
- Recently experienced a fire, flood, or other natural or human-caused disaster that resulted in substantial damage to the individual's property
- Filed for bankruptcy in the last six months
- Incurred unreimbursed medical expenses in the last 24 months that resulted in substantial debt
- Experienced unexpected increases in essential expenses due to caring for an ill, disabled, or aging family member

37. Treas. Reg. §1.5000A-3(f)(3).

38. 45 CFR §155.605(g).

39. Center for Medicare and Medicaid Services correspondence from Gary Cohen, CMS Deputy Administrator and Director. Jun. 26, 2013.

- Are children who are determined ineligible for Medicaid and CHIP, and for whom a party other than the taxpayer who expects to claim them as a dependent is required by court order to provide medical support (This exemption is only provided for the months during which the medical support order is in effect.)
- As a result of an eligibility appeals decision, are determined eligible for enrollment in a qualified health plan (QHP) through the Marketplace, advance PAC, or cost-sharing reductions for the period during which they were not enrolled in a QHP through the Marketplace (This exemption is only provided for the period affected by the appeals decision.)

Affordable Coverage Unavailable Based on Projected Income. It is also mandatory that the Markeplace grant an exemption to an individual if they can demonstrate that they are unable to afford coverage based on **projected** annual household income for the year.

> **Note.** This exemption protects individuals who decline to obtain coverage because the Marketplace projects that coverage will be unaffordable but who later discover that their actual income for the year is too high to qualify for the **affordable coverage unavailable** exemption discussed earlier.

Under the rules for this exemption, the individual's required contribution is generally the same as used under the **affordable coverage unavailable** method. Application for this exemption must be made before the last day on which the individual could enroll in a health plan through the Marketplace for the months for which the exemption is being requested. The Marketplace granting this exemption must make the exemption available for all remaining months in the coverage year regardless of any changes in the individual's circumstances during the coverage year.

Ineligible for Medicaid in Non-Expansion State. Generally, the federal and state governments share the cost of the Medicaid program available in each state. An integral part of health care reform is the expansion of Medicaid to groups previously ineligible for this poverty-based program. The expansion includes covering newly eligible individuals age 19 to 65 whose incomes are below 133% of the federal poverty guideline and who are not eligible for Medicare. Expanded coverage also includes new eligibility guidelines for certain children, pregnant women, and families. However, not all states have decided to expand Medicaid.

> **Note.** Further details on Medicaid expansion are available at **www.healthcare.gov/what-if-my-state-is-not-expanding-medicaid.**
>
> For a list of states that have joined in the expanded Medicare program, see **http://kff.org/health-reform/state-indicator/state-activity-around-expanding-medicaid-under-the-affordable-care-act.** This list is expected to be updated as necessary.

If an individual is ineligible for Medicaid for one or more months during a year solely because that individual resides in a state that has decided not to expand Medicaid, the Marketplace **must** issue a hardship exemption to that individual for the entire calendar year.

Eligible for Services through an Indian Health Care Provider. The Marketplace must declare applicants exempt from the individual mandate for any month that they are an Indian who is eligible for services through an Indian healthcare provider[40] and not otherwise eligible for the income below the filing threshold exemption. It must also exempt individuals eligible for services through the Indian Health Service.[41]

40. As defined in 42 CFR 447.50.

41. In accordance with 25 USC 1680c(a), (b), or (d)(3).

Hardship Exemptions Administered by the IRS. Under the final HHS hardship exemption regulations, the IRS approves hardship exemptions for the following situations. **The IRS indicated that these hardship exemptions should be claimed on an income tax return.**[42]

- Taxpayers would have met the income below filing threshold exemption, except that they filed a tax return to obtain a tax benefit (such as the EIC) and they claimed a dependent who had their own income during that tax year. That income must be included when computing household income. As a result, the household income was over the applicable filing threshold.[43]
- Two or more individuals have coverage available through their own respective employers. As individuals, they do not meet the "affordable coverage unavailable" exemption. However, the overall cost of health insurance is **above 8%** of their combined household income.

Example 11. Dean and Donna are married. In 2014, Dean works as manager for a sheet metal company and earns $35,000. Donna is a nurse who works at a nursing home. Her 2014 wages are $42,000. Their salaries comprise all of their 2014 income.

Each spouse is able to obtain self-only coverage through their employers. Accordingly, neither spouse may be considered a related individual of the other and each spouse's ability to obtain affordable coverage must be evaluated separately.

Dean's salary	$35,000
Donna's salary	42,000
Household income	$77,000
	× 8%
8% of household income	$ 6,160
Lowest-cost self-only coverage available through Dean's employer's plan	$ 4,800
Lowest-cost self-only coverage available through Donna's employer's plan	3,200
Total cost of coverage for both spouses	$ 8,000

Because the cost of health insurance for **each spouse** under their respective employer-provided plans is less than $6,160 (8% of household income), **each spouse** has **affordable coverage available.** Therefore, **neither spouse** is able to claim the **affordable coverage unavailable** exemption.

However, because their overall cost of $8,000 exceeds $6,160, they are eligible for the hardship version of the **affordable coverage unavailable** exemption. This hardship exemption may be claimed on their 2014 tax return.[44] This exemption is claimed on Part III of their 2014 Form 8965.

4. Short-Coverage Gap Period Exemption

An individual does not incur a penalty for failure to maintain MEC for themselves or for dependents during a period that qualifies as a **short-coverage gap.**[45] Generally, a short-coverage gap is a continuous period of **less than three months** during which the individual does not have qualifying health coverage.[46] This rule is subject to the general rule that if the individual has coverage in effect for at least one day of the month, coverage is considered in effect for that whole month.[47]

42. Treas. Reg. §1.5000A-3(h)(3).
43. 45 CFR §155.605(g).
44. Treas. Reg. §1.5000A-3(h)(3).
45. IRC §5000A(e)(4).
46. Treas. Reg. §1.5000A-3(j).
47. Treas. Reg. §1.5000A-1(b)(1).

An individual is only allowed **one** short-coverage gap period per tax year. If more than one gap period occurs within a tax year, the individual is entitled to this exemption for only the **earliest** of the qualifying gap periods.[48] Months during which coverage does not exist but for which the taxpayer qualifies for another exemption do not count towards the gap period.[49]

Example 12. Gordon is a single individual. During 2014, he had MEC from January 1 through March 3. After March 3, he lost his job and had no coverage.

Fortunately, Gordon is successful at getting another job and begins it on June 28, 2014. His new employer-sponsored health insurance coverage becomes immediately effective. Gordon remains employed and retains his employer-sponsored coverage through the end of 2014.

Gordon is considered to have coverage in effect for the months of January, February, and March. The entire month of March counts as a month during which Gordon has MEC because he has MEC in place for **at least one day** during March. He is also considered to have MEC for the months of June through December.

He had **no MEC during April and May.** Because this is a continuous period of **less than three months,** it is a short-coverage gap period and qualifies for this exemption. Gordon does not incur a penalty for failure to have MEC in place for this short-coverage gap period.

Although a short-coverage gap of less than three months is penalty-free under this exemption, a gap of **three months or longer** results in the entire noncoverage period being subject to the penalty.

Example 13. Use the same facts as **Example 12,** except that Gordon's new employment and employer-sponsored coverage begins on July 2, 2014, instead of June 28. Gordon is deemed to have MEC during January through March. He is also deemed to have MEC during July through December.

April, May, and June are noncoverage months. Because this period is **three months or longer,** Gordon **is subject** to a penalty for failure to maintain MEC.

Special Rule for Periods that Straddle Tax Years. The 3-month threshold period for a short-coverage gap period is determined **without reference** to the calendar year and therefore may straddle two tax years.[50] If a gap period straddles two tax years, the gap period months in the second year are not considered in connection with the first year. However, the **gap period months that occur in the first year are taken into account in the second year.**[51]

> **Note.** This rule reflects the fact that a taxpayer may not be able to make a timely determination about whether there is a short-coverage gap for the first year if months in the following year must be taken into account.

Example 14. Alissa has coverage from January 1 through October 27, 2014. She does not obtain coverage again until February 28, 2015. During 2014, Alissa's coverage gap consists of November and December. Because this coverage gap is **shorter than three months,** Alissa owes no penalty for 2014.

However, her coverage gap for 2015 includes November and December 2014 and January 2015. February 2015 counts as a month during which Alissa maintained coverage because she had coverage for at least one day of the month. Because the 2015 coverage gap is three months or longer, Alissa is subject to a penalty for 2015 in connection with the entire noncoverage period.

48. Treas. Reg. §1.5000A-3(j)(2)(iii).

49. Treas. Reg. §1.5000A-3(j)(2)(ii).

50. IRC §5000A(e)(4).

51. Treas. Reg. §1.5000A-3(j)(3)(ii).

TAXPAYER LIABILITY FOR PENALTY[52]

An individual who does not qualify for any of the exemptions is liable for a penalty for any month in which they did not have MEC. The penalty is called the **shared responsibility payment (SRP).** Joint filers are jointly liable for the SRP. In addition, taxpayers are liable for the SRP for any month that their dependents do not have the required health insurance coverage.

An applicable individual who fails to maintain coverage for some or all of the tax year is subject to the SRP. The taxpayer must report the SRP on their tax return. **Taxpayers are first subject to the SRP on their 2014 income tax returns.** The SRP's **phasein period** begins in 2014 and continues in 2015 with higher rates. The SRP reaches its maximum level in 2016.

Rules for Dependents

A taxpayer is liable for SRPs for any dependents who do not have MEC.[53] An individual meeting the definition of a dependent is considered a dependent under individual mandate rules **even if the taxpayer does not actually claim a dependency exemption for that individual.**

However, if the dependency exemption may be claimed by more than one taxpayer, the one who **properly claims** it is liable for any SRP arising from a lack of MEC for that dependent.

Example 15. Fred and Pam are divorced. Pam is the custodial parent of their 14-year-old daughter, Kyra. Neither Fred nor Pam obtain MEC for Kyra. Because Pam is the custodial parent, she is entitled to claim the dependency exemption for Kyra. However, for 2014, Pam agrees to transfer her right to the dependency exemption to Fred. Accordingly, she completes and signs the required Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent.*

If Fred claims Kyra's exemption, he is liable for the 2014 SRP unless he meets one of the exemptions.

If more than one taxpayer may claim an individual as a dependent in the same calendar year but no one does so, the taxpayer with priority rights under IRC §152 is liable for the SRP for the individual.

Example 16. Toni lives with her mother Alex and her 1-year-old daughter Lilly. Lilly meets the definition of qualifying child for both Alex and Toni. As the child's mother, Toni has priority rights to Lilly's dependency exemption. If no one claims Lilly's dependency exemption on their 2014 return, Toni is responsible for any SRP resulting from Lilly not having MEC.

> **Note.** For more information on the rules related to dependency exemptions, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 3: Filing Status and Dependency Exemptions. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

52. Treas. Reg. §1.5000A-1(c).

53. IRC §5000A(b)(3)(A).

Observations Regarding Dependents

1. The use of Form 8332 is an important issue that has not been directly addressed by the IRS. For example, if a custodial parent signs the release and the noncustodial parent does not claim the dependent's exemption, the custodial parent is liable for any SRP. It is immaterial whether that taxpayer was unaware that the dependency exemption went unclaimed for that tax year.

2. A noncustodial parent may be obligated under a separation or divorce decree to provide health insurance coverage for their child. However, the Code does not provide the IRS with the flexibility to assign the penalty liability to the noncustodial parent if that parent does not claim the child's exemption. A custodial parent who paid the SRP would have to resort to the courts for restitution in this case.

3. In **Example 15,** if Fred, as the noncustodial parent, is required under a separation or divorce decree to provide Kyra with MEC and Kyra does not qualify for other coverage, it appears that Pam may be able to apply for a hardship exemption to avoid liability for the SRP attributable to Kyra.[54]

3

> **Note.** Specific guidance and special rules for children who are adopted, given up for adoption, or in foster care situations are found in Treas. Reg. §1.5000A-1(c)(2)(ii).

CALCULATION OF THE SRP[55]

The SRP for a taxpayer who does not have MEC is the **greater of:**

- The **flat-dollar-amount penalty,** or
- The **percentage-of-income penalty.**

The SRP is **capped** at the cost of the national average premium for **a bronze-level health plan** available through the **Marketplace** for the tax year.[56] The Marketplace offers four levels of MEC, with the **bronze level being the least expensive.**

For **2014,** the SRP is calculated as follows.

Step 1. Calculate the **flat-dollar-amount penalty.** The flat-dollar amount is the **lesser of:**

- **$95 per adult in the household plus $47.50 per child under age 18** who did not have MEC for the full 12 months of the year, **or**
- Three times the applicable dollar amount of $95 (or $285).

> **Note.** The annual flat-dollar amount for an individual turning 18 during the year is calculated by prorating the pre- and post-age-18 amounts. The $47.50 amount is used for the months during the year that the child was not 18 at the beginning of the month.[57]

54. TD 9632, 2013-39 IRB 241.

55. IRC §5000A(b)(1).

56. *The Individual Shared Responsibility Provision*. May 27, 2014. [www.irs.gov/uac/Individual-Shared-Responsibility-Provision] Accessed on Jun. 28, 2014.

57. IRC §5000A(c)(3)(C).

Example 17. Fred and Sheila Morganstern file jointly for 2014 and have three children: Steven, Stephanie, and Francis. Francis was over age 18 for the entire tax year. Steven and Stephanie are under age 18.

Fred and Sheila do not qualify for any exemption to the individual mandate's requirement for MEC. For 11 months of 2014, neither they nor their children had MEC.

The following applicable dollar amounts apply to each member of the household.

Family Member	Applicable Dollar Amount
Fred	$ 95.00
Sheila	95.00
Steven	47.50
Stephanie	47.50
Francis	95.00
Total for the family	$380.00

The total monthly flat-dollar penalty for the Morganstern family is **$31.67 ($380 ÷ 12).** Because they did not have MEC for **11 months** of the year, their potential flat-dollar penalty is **$348.37 ($31.67 × 11 months).**

The maximum flat-dollar penalty for the Morgansterns for 2014 is **$285 (3 × $95).** Because the Morgansterns did not have MEC for 11 months of the year, the maximum flat-dollar penalty is **prorated** for the 11 months of noncompliance. The maximum is $261.25 ((11 ÷ 12) × $285), which is **the flat-dollar penalty for the Morganstern family.**

Step 2. Calculate the **percentage-of-income penalty.** For 2014, this is **1.0%** of the taxpayer's household income in excess of the filing threshold that applies to the taxpayer. To arrive at **household income** for the year, the MAGI amounts of the household members are totaled.[58] Household members include only those who are **required to file** a tax return. They include the following persons.

- The taxpayer
- The taxpayer's spouse if filing MFJ
- Any dependents claimed by the taxpayer, but only if the dependent's MAGI exceeds their filing threshold for the year (This includes dependents subject to the "kiddie tax" whose incomes are not reported on a parent's return.)

For purposes of this rule, MAGI is calculated as follows.

Adjusted gross income (AGI)
\+ Any amount excluded from AGI as foreign earned income or foreign housing amount under IRC §911
\+ Any tax-exempt interest reported by the taxpayer for the year
MAGI

58. IRC §5000A(c)(4)(B).

Example 18. Use the same facts as **Example 17.** The Morganstern family's household income is $58,000 and the 2014 filing threshold for Fred and Sheila is $20,300.

The amount of income **in excess** of the filing threshold is $37,700 ($58,000 − $20,300). Because the 2014 percentage-of-income rate is **1%,** the applicable 2014 **percentage-of-income penalty is $377 (1% × $37,700).**

The monthly percentage-of-income penalty is $31.42 ($377 ÷ 12). Because the Morgansterns did not have coverage for 11 months of the year, their 2014 **percentage-of-income penalty is $345.62 (11 × $31.42).**

Step 3. Determine the **greater** amount: the **flat-dollar-amount penalty (Step 1)** or the **percentage-of-income penalty (Step 2).**

The penalty **is capped** at the **national average cost** for a **bronze-level** qualified health plan offered through the Marketplace for the taxpayer and any family members for whom MEC was required.

Example 19. Use the same facts as **Example 17** and **Example 18.** The national average cost for bronze-level coverage for the Morganstern family is $4,500.

The **greater** of the penalty calculated in **Step 1 (Example 17)** and **Step 2 (Example 18)** is $346.

The SRP for the family is capped at $4,500, the cost of bronze-level coverage through the Marketplace.

The $346 SRP determined by completing Steps 1 and 2 is less than the cap of $4,500. Therefore, the Morgansterns' SRP for failure to maintain MEC during 2014 is **$346.** This amount must be reported on Fred and Sheila's 2014 tax return.

PENALTIES DURING THE PHASEIN PERIODS

The first year of the SRP phasein period is 2014. In 2016, it is fully phased in.

The following table shows the applicable amounts to use for calculating the **flat-dollar penalty** for 2014 to 2016.

	Applicable Dollar Amount	
Year	**Individual Age 18 or Older**	**Individual Under Age 18**
2014	$ 95.00	$ 47.50
2015	325.00	162.50
2016	695.00	347.50

For tax years **after 2016,** the $695.00 and $347.50 amounts are **subject to adjustment for inflation.**[59]

The **percentage-of-income penalty** increases from 1% in 2014 to **2% in 2015** and **2.5% in 2016.**[60]

Once these penalty provisions are fully phased in for 2016 and subsequent years, the potential penalties are much greater.

59. IRC §5000A(c)(3)(D)(ii).

60. IRC §5000A(c)(2)(B).

Example 20. Use the same facts as **Example 17, Example 18, and Example 19,** except the tax year in which the Morgansterns did not have MEC for 11 months is **2016.** Their penalty is calculated as follows.

Step 1. **Calculation of flat-dollar penalty.** The following table shows the computation of the 2016 flat-dollar penalty of $1,911 (rounded).

Family Member	Applicable Dollar Amount
Fred	$ 695.00
Sheila	695.00
Steven	347.50
Stephanie	347.50
Francis	695.00
Total for the family	$2,780.00
	÷ 12
Monthly flat-dollar penalty	$ 231.67
Number of months without MEC	× 11
Potential flat-dollar penalty	$2,548.37
Applicable dollar amount	$ 695.00
	× 3
Maximum flat-dollar penalty	$2,085.00
	× 11/12
Maximum penalty prorated by months without MEC	$1,911.25
Step 1 Result: lesser of potential or maximum penalty	**$1,911.25**

Step 2. **Calculation of the percentage-of-income penalty.**

The amount of the Morgansterns' 2016 income in excess of the filing threshold is $37,700.

Because the percentage-of-income penalty rate for 2016 is **2.5%,** the applicable percentage-of-income penalty is $942.50 (2.5% × $37,700).

The monthly percentage-of-income penalty is $78.54 ($942.50 ÷ 12). Because the family did not have MEC for 11 months during 2016, **their percentage-of-income penalty for 2016 is $863.94 (11 × $78.54).**

Step 3. The **greater of** the calculated flat-dollar penalty ($1,911) and percentage-of-income penalty ($864) is **$1,911.**

The 2016 SRP for the Morganstern family is capped at $4,500, the 2016 national average cost of bronze-level coverage through the Marketplace.

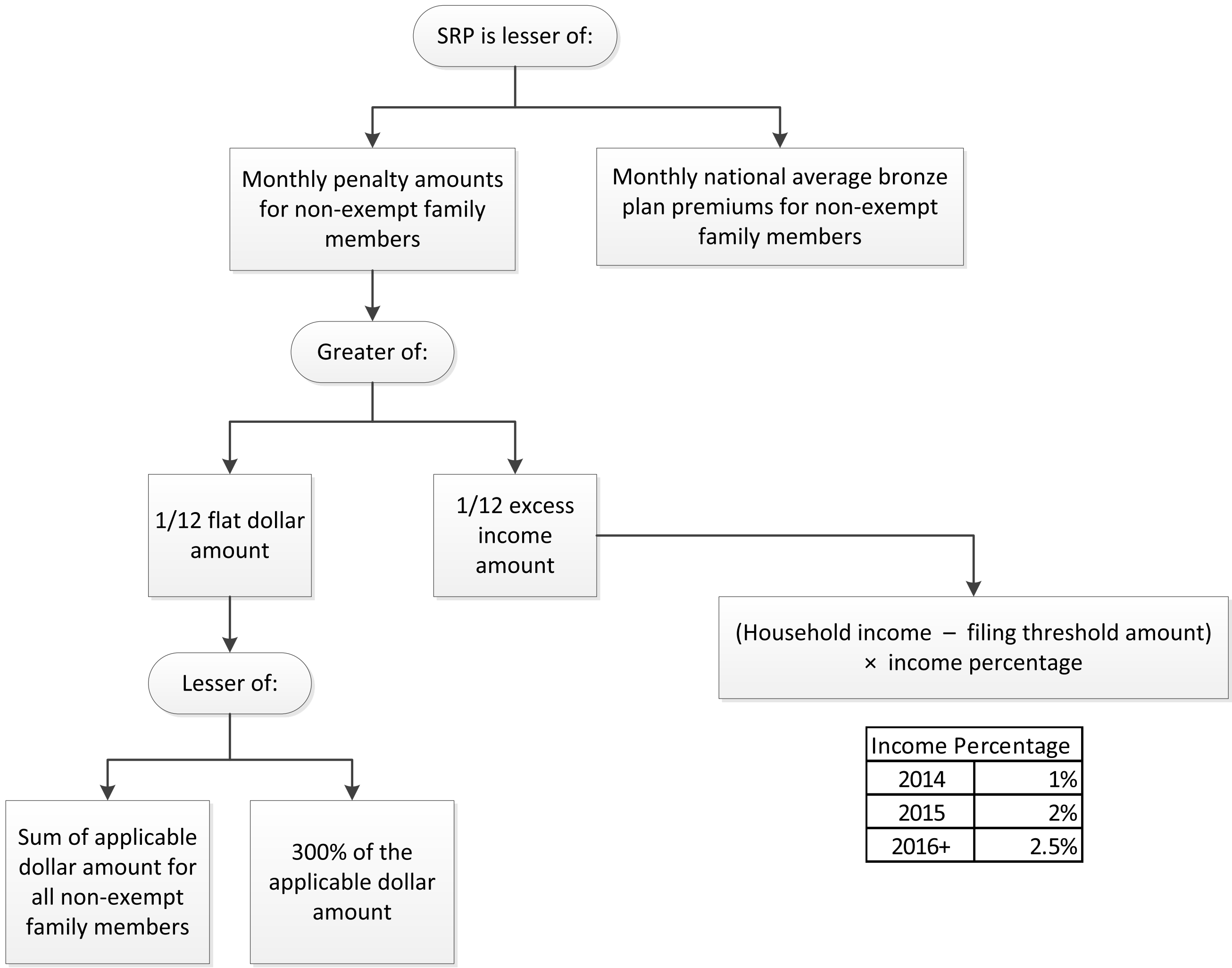
Because the Morgansterns did not have MEC for 11 months of 2016, their SRP is **$1,911.** This amount must be reported on the 2016 tax return filed by Fred and Sheila.

Note. If a **taxpayer and spouse** file a joint return, the two individuals are **jointly liable** for the SRP.[61]

61. IRC §5000A(b)(3)(B).

The following flow chart summarizes the SRP calculations for the individual mandate under IRC §5000A.

Individual SRP Flowchart



Income Percentage	
2014	1%
2015	2%
2016+	2.5%

Applicable Dollar Amount	
2014	$ 95
2015	325
2016	695
2017+	indexed
1/2 the above amount for those under age 18	

MARKETPLACE REPORTING TO THE IRS[62]

For 2014 and all subsequent years, the IRS expects the Marketplace to furnish a written statement to each individual who has enrolled one or more family members in a qualified health plan through the Marketplace. The written statement must include information that the Marketplace reports to the IRS annually. The Marketplace may use **Form 1095-A, *Health Insurance Marketplace Statement,*** to report the information. It must furnish the statement to the enrollees on or **before January 31 of the year following** the calendar year of coverage.

This reporting is necessary to ensure that the taxpayer has sufficient tax information to calculate and reconcile their PAC. It also ensures that the IRS has the same information to confirm the taxpayer's eligibility for the PAC and for the amount claimed on a tax return.

Treas. Reg. §1.36B-5 uses the term **tax filer** to identify the individuals on behalf of whom advance PAC payments are made. The term **responsible adult** is used to describe similar individuals who do **not** receive advance PAC payments. The regulations require the Marketplace to provide the following information to both the tax filer/responsible adult and the IRS.

- The name, address, and taxpayer identification (TIN) of the person who is the tax filer/responsible adult for the coverage obtained (or birth date if the TIN is not available)
- The name, address, and TIN of the tax filer's spouse (or birth date if the TIN is not available)
- The amount of advance PAC paid for coverage under the plan each month
- The premium for the applicable benchmark plan that is required to calculate the advance PAC payments
- The names and TINs of all other individuals (or birth dates if TINs are not available) covered under the plan
- The coverage start and end dates of the MEC in effect through the Marketplace
- The total premium paid (before application of any advance PAC) for the MEC coverage by the taxpayer for self and family coverage (The cost of MEC coverage in this case excludes the premium allocated to benefits in excess of essential health benefits but includes certain pediatric dental premiums.)
- The name of the qualified health plan issuer
- The Marketplace-assigned policy identification number (which may be different than the insurance issuer's policy number)
- The Marketplace's unique identifier
- Any other information required in published guidance that is necessary to determine the tax filer's eligibility for PAC, the amount of any excess PAC obtained, and whether any change of circumstances affected their PAC eligibility

These regulations do not apply to individuals who obtain health care coverage through a Small Business Health Options Program (SHOP) exchange (explained later). However, according to the IRS, SHOP exchanges must report information concerning employer participation, employer contributions, and employee enrollment. The time and format of this reporting is determined by the HHS.

62. TD 9663, 2014-22 IRB 1038.

PREMIUM ASSISTANCE CREDIT/PREMIUM TAX CREDIT

> **Note.** The terms **premium assistance credit** and **premium tax credit** are used synonymously. The ACA provisions refer to the credit as the "premium assistance credit" and IRS Form 8962 refers to it as the "premium tax credit." In the following section, the credit is referred to as the premium assistance credit (PAC).

Individuals who purchase coverage through the Marketplace may be entitled to the PAC. The PAC is a refundable, sliding-scale income tax credit. It is available to to **qualifying taxpayers** with **household incomes** between 100 and 400% of the **federal poverty guidelines** for the family size involved and who do not receive coverage through either the taxpayer's employer or the spouse's employer. Taxpayers with incomes above 400% of the federal poverty guideline do not qualify for the PAC.

Taxpayers with incomes below 100% of the federal poverty guideline may still qualify for the PAC under special rules. A taxpayer with a household income below 100% of the federal poverty guideline for their family size is treated as a qualifying taxpayer if they meet the following conditions.

- The taxpayer or a family member actually enrolls in a qualified health plan purchased through the Marketplace.
- At the time of enrollment, the Marketplace estimates the taxpayer's household income will be in the 100 to 400% range necessary to qualify for the PAC.
- Advance credits are authorized and paid for one or more months during the year.
- If the taxpayer's income were actually in the 100 to 400% range, that taxpayer would be an applicable individual.

One factor used in the calculation that determines the amount of PAC to which the taxpayer is entitled is the cost of the "**second lowest cost silver plan**" that is available to the taxpayer in the Marketplace.[63] The second lowest-cost silver plan is referred to as the **applicable benchmark plan.**[64] The applicable benchmark plan is generally self-only coverage for either single taxpayers without dependents or family coverage for taxpayers with a spouse and/or dependents.

> **Note**. In order to qualify for the PAC, taxpayers who are married at the end of the tax year must file MFJ.

Calculating the PAC amount for a qualifying taxpayer begins by analyzing their income against a sliding scale. The low end of the sliding scale is 100% of the poverty income guideline for the taxpayer, based on the number of persons in the taxpayer's family. The high end of the scale is 400% of the poverty income guideline that applies to the taxpayer based on family size. If the taxpayer's household income is not within these two end points of the sliding scale, the taxpayer does not qualify for the PAC.

The taxpayer's household income is multiplied by the applicable percentage to arrive at the annual contribution for healthcare. The applicable percentage depends on where the taxpayer's household income falls on the sliding scale.

---

63. IRC §36B(b)(2)(B)(i).

64. Treas. Reg. §1.36B-3(f).

The sliding scale is **tiered**. A lower and upper applicable percentage define each tier. The sliding scale's tiers and the applicable percentages for each tier are summarized as follows.

Amount of Household Income [a]	Lower Applicable Percentage [b]	Upper Applicable Percentage [c]
100% to 133%	2.00%	2.00%
133% to 150%	3.00%	4.00%
150% to 200%	4.00%	6.30%
200% to 250%	6.30%	8.05%
250% to 300%	8.05%	9.50%
300% to 400%	9.50%	9.50%

[a] Expressed as a percentage of the poverty income guideline for the taxpayer's family size.
[b] Also referred to as the "Initial Premium Percentage."
[c] Also referred to as the "Final Premium Percentage."

Note. The HHS poverty guidelines refer to a premium percentage, but Form 8962 refers to the percentage as an "applicable figure."

For taxpayers with household incomes within an income tier in the above table, the income and the applicable percentage are **linearly** related. Accordingly, a taxpayer with household income of 141.5% of the poverty income guideline falls into the second tier and is exactly at the midpoint between 133% and 150%. That taxpayer's applicable percentage is therefore at the midpoint between the lower 3% and upper 4% applicable percentages (which is 3.5%).

CALCULATING THE PAC

The taxpayer's PAC is the lesser of:

1. The premiums paid, or
2. The cost of the applicable benchmark plan available to the taxpayer minus the annual contribution for healthcare. This is expressed by the following formula.

$$\textbf{Amount of PAC available} = \textbf{Cost of applicable benchmark plan available to the taxpayer} - \textbf{Annual contribution for healthcare}$$

Observation. The above formula illustrates how the taxpayer's PAC is tied to the cost of the applicable benchmark plan available in the Marketplace. In addition, the annual contribution for healthcare is based on income and family size, which also impacts the taxpayer's PAC.

Example 21. Holly is a single taxpayer living in Illinois. She has no dependents. Her 2014 MAGI is $28,725. The federal poverty amount for the 48 states and the District of Columbia, shown in the Form 8962 instructions (2014) for her state and family size is $11,490. Therefore, her MAGI (household income) is 250% ($28,725 ÷ $11,490) of the federal poverty guideline. Her applicable figure is 8.05%.

She purchased insurance from the Marketplace that had a monthly premium of $350 and received a $100 per month advance payment of her PAC (applied against her premium). The cost of the second lowest-cost silver plan (SLCSP) in the Marketplace was $4,800.

Holly's completed Form 8962, *Premium Tax Credit,* follows.

For Example 21

Form **8962**

Department of the Treasury
Internal Revenue Service

Premium Tax Credit (PTC)

▶ Attach to Form 1040, 1040A, or 1040NR.
▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962*.

OMB No. 1545-0074
2014
Attachment Sequence No. 73

3

Name shown on your return	Your social security number	Relief (see instructions) ☐
Holly	888-88-8888	

DRAFT AS OF July 24, 2014 DO NOT FILE

Part 1: Annual and Monthly Contribution Amount

1	Family Size: Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d	1	1
2a	Modified AGI: Enter your modified AGI (see instructions) . . . 2a 28,725 **b** Enter total of your dependents' modified AGI (see instructions)	2b	0
3	Household Income: Add the amounts on lines 2a and 2b	3	28,725
4	Federal Poverty Line: Enter the federal poverty amount as determined by the family size on line 1 and the federal poverty table for your state of residence during the tax year (see instructions). Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☒ Other 48 states and DC	4	11,490
5	Household Income as a Percentage of Federal Poverty Line: Divide line 3 by line 4. Enter the result rounded to a whole percentage. (For example, for 1.542 enter the result as 154, for 1.549 enter as 155.) (See instructions for special rules.)	5	250 %
6	Is the result entered on line 5 less than or equal to 400%? (See instructions if the result is less than 100%.) ☒ **Yes. Continue to line 7.** ☐ **No.** You are not eligible to receive PTC. If you received advance payment of PTC, see the instructions for how to report your Excess Advance PTC Repayment amount.		
7	Applicable Figure: Using your line 5 percentage, locate your "applicable figure" on the table in the instructions	7	8.05%
8a	Annual Contribution for Health Care: Multiply line 3 by line 7 . . . . 8a 2,312 **b** Monthly Contribution for Health Care: Divide line 8a by 12. Round to whole dollar amount	8b	193

Part 2: Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Did you share a policy with another taxpayer or get married during the year and want to use the alternative calculation? (see instructions)
☐ **Yes.** Skip to Part 4, Shared Policy Allocation, or Part 5, Alternative Calculation for Year of Marriage. ☒ **No. Continue to line 10.**

10 Do all Forms 1095-A for your tax household include coverage for January through December with no changes in monthly amounts shown on lines 21–32, columns A and B?
☒ **Yes. Continue to line 11.** Compute your annual PTC. Skip lines 12–23 and continue to line 24. ☐ **No. Continue to lines 12–23.** Compute your monthly PTC and continue to line 24.

Annual Calculation	**A.** Premium Amount (Form(s) 1095-A, line 33A)	**B.** Annual Premium Amount of SLCSP (Form(s) 1095-A, line 33B)	**C.** Annual Contribution Amount (Line 8a)	**D.** Annual Maximum Premium Assistance (Subtract C from B)	**E.** Annual Premium Tax Credit Allowed (Smaller of A or D)	**F.** Annual Advance Payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals	4,200	4,800	2,312	2,488	2,488	1,200
Monthly Calculation	**A.** Monthly Premium Amount (Form(s) 1095-A, lines 21–32, column A)	**B.** Monthly Premium Amount of SLCSP (Form(s) 1095-A, lines 21–32, column B)	**C.** Monthly Contribution Amount (Amount from line 8b or alternative marriage monthly contribution)	**D.** Monthly Maximum Premium Assistance (Subtract C from B)	**E.** Monthly Premium Tax Credit Allowed (Smaller of A or D)	**F.** Monthly Advance Payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						

24	Total Premium Tax Credit: Enter the amount from line 11E or add lines 12E through 23E and enter the total here	24	2,488
25	Advance Payment of PTC: Enter the amount from line 11F or add lines 12F through 23F and enter the total here	25	1,200
26	Net Premium Tax Credit: If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27	26	1,288

Part 3: Repayment of Excess Advance Payment of the Premium Tax Credit

27	Excess Advance Payment of PTC: If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here	27	
28	Repayment Limitation: Using the percentage on line 5 and your filing status, locate the repayment limitation amount in the instructions. Enter the amount here	28	
29	Excess Advance Premium Tax Credit Repayment: Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44	29	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37784Z Form **8962** (2014)

This net PAC of $1,288 is shown as an additional payment on page 2 of Holly's Form 1040.

Note. The numbers entered on lines 4 and 7 of Form 8962 presumably will be found in the instructions for the form. HHS provides federal poverty guideline amounts each year. The 2013 guidelines are used for the 2014 PAC (line 4). The amounts vary based on family size. One table is provided for the 48 contiguous states and the District of Columbia and separate tables are provided for Alaska and Hawaii residents.

Observation. The preparer must ask their clients questions in order to accurately complete Form 8962. Other challenges not addressed in **Example 21** include dealing with dependents (line 2b), shared-policy allocations (Part 4), and alternative calculations for the year of marriage (Part 5). Obtaining Form 1095-A from the client is also critical.

RECOVERY OF EXCESS ADVANCE CREDIT PAYMENTS

If the advance credit payments exceed the PAC amount for which the taxpayer actually qualifies, the excess is recovered in the form of an additional tax liability on the taxpayer's return for the year.[65]

However, for taxpayers with household incomes of **less than 400%** of the poverty income guidelines for their family size, there is a cap on the amount of additional tax liability that will be imposed in order to recover any excess advance credit payments. The cap for these taxpayers is shown in the following table.

Household Income Percentage of Poverty Income Guideline	Maximum Additional Tax Liability for Single Taxpayers[66] (Except Surviving Spouses and Head of Household Filers)	Maximum Additional Tax Liability for All Other Taxpayers
Less than 200%	$ 300	$ 600
At least 200% but less than 300%	750	1,500
At least 300% but less than 400%	1,250	2,500

Note. The amounts in the above table will be adjusted for inflation, rounded to the next lowest $50 increment, beginning after 2014.

Example 22. Use the same facts as **Example 21,** except Holly received an advance payment of $3,000 ($250 per month).

Holly's completed Form 8962 follows. The excess advance PAC repayment is shown on line 46 of her 2014 Form 1040 (not shown).

Note. The recovery of excess advance PAC payments was discussed in the 2012 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 7: Healthcare Reform Act. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

65. Treas. Reg. §1.36B-4(a)(1)(i).

66. This category applies to those taxpayers covered under IRC §1(c).

For Example 22

Form **8962** | Department of the Treasury Internal Revenue Service

Premium Tax Credit (PTC)

▶ Attach to Form 1040, 1040A, or 1040NR.
▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962*.

OMB No. 1545-0074
2014
Attachment Sequence No. 73

Name shown on your return	Your social security number	Relief (see instructions) ☐
Holly	888-88-8888	

Part 1: Annual and Monthly Contribution Amount

1	Family Size: Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d .	1	1
2a	Modified AGI: Enter your modified AGI (see instructions) . . . . . . **2a** 28,725 — **b** Enter total of your dependents' modified AGI (see instructions)	2b	0
3	Household Income: Add the amounts on lines 2a and 2b	3	28,725
4	Federal Poverty Line: Enter the federal poverty amount as determined by the family size on line 1 and the federal poverty table for your state of residence during the tax year (see instructions). Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☒ Other 48 states and DC	4	11,490
5	Household Income as a Percentage of Federal Poverty Line: Divide line 3 by line 4. Enter the result rounded to a whole percentage. (For example, for 1.542 enter the result as 154, for 1.549 enter as 155.) (See instructions for special rules.)	5	250 %
6	Is the result entered on line 5 less than or equal to 400%? (See instructions if the result is less than 100%.) ☒ **Yes. Continue to line 7.** ☐ **No.** You are not eligible to receive PTC. If you received advance payment of PTC, see the instructions for how to report your Excess Advance PTC Repayment amount.		
7	Applicable Figure: Using your line 5 percentage, locate your "applicable figure" on the table in the instructions . .	7	8.05%
8a	Annual Contribution for Health Care: Multiply line 3 by line 7 . . . . **8a** 2,312 — **b** Monthly Contribution for Health Care: Divide line 8a by 12. Round to whole dollar amount	8b	193

Part 2: Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Did you share a policy with another taxpayer or get married during the year and want to use the alternative calculation? (see instructions)
☐ **Yes.** Skip to Part 4, Shared Policy Allocation, or Part 5, Alternative Calculation for Year of Marriage. ☒ **No. Continue to line 10.**

10 Do all Forms 1095-A for your tax household include coverage for January through December with no changes in monthly amounts shown on lines 21–32, columns A and B?
☒ **Yes. Continue to line 11.** Compute your annual PTC. Skip lines 12–23 and continue to line 24. ☐ **No. Continue to lines 12–23.** Compute your monthly PTC and continue to line 24.

Annual Calculation	**A.** Premium Amount (Form(s) 1095-A, line 33A)	**B.** Annual Premium Amount of SLCSP (Form(s) 1095-A, line 33B)	**C.** Annual Contribution Amount (Line 8a)	**D.** Annual Maximum Premium Assistance (Subtract C from B)	**E.** Annual Premium Tax Credit Allowed (Smaller of A or D)	**F.** Annual Advance Payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals	4,200	4,800	2,312	2,488	2,488	3,000
Monthly Calculation	**A.** Monthly Premium Amount (Form(s) 1095-A, lines 21–32, column A)	**B.** Monthly Premium Amount of SLCSP (Form(s) 1095-A, lines 21–32, column B)	**C.** Monthly Contribution Amount (Amount from line 8b or alternative marriage monthly contribution)	**D.** Monthly Maximum Premium Assistance (Subtract C from B)	**E.** Monthly Premium Tax Credit Allowed (Smaller of A or D)	**F.** Monthly Advance Payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						

24	Total Premium Tax Credit: Enter the amount from line 11E or add lines 12E through 23E and enter the total here .	24	2,488
25	Advance Payment of PTC: Enter the amount from line 11F or add lines 12F through 23F and enter the total here .	25	3,000
26	Net Premium Tax Credit: If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 .	26	

Part 3: Repayment of Excess Advance Payment of the Premium Tax Credit

27	Excess Advance Payment of PTC: If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here	27	512
28	Repayment Limitation: Using the percentage on line 5 and your filing status, locate the repayment limitation amount in the instructions. Enter the amount here	28	750
29	Excess Advance Premium Tax Credit Repayment: Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44	29	512

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37784Z Form **8962** (2014)

EMPLOYER MANDATE

The following acronyms are used in this section.

- ACA — Affordable Care Act
- ALE — Applicable large employer
- DOL — Department of Labor
- FTE — Full-time equivalents
- HBE — Health benefit exchange
- MAGI — Modified adjusted gross income
- MEC — Minimum essential coverage
- PAC — Premium assistance credit
- QHP — Qualified health plan
- SHOP — Small Business Health Options Program

The ACA imposes numerous requirements on applicable large employers (ALEs) for coverage provided to employees. On February 12, 2014, the IRS issued final regulations on the shared responsibility for employers regarding health coverage.[67] The new regulatory guidance for employers is too voluminous to allow full coverage of it within this chapter. However, this section provides updated information about changes in the implementation of the employer mandate rules for certain employers and the employer reporting requirements.

> **Note.** For further details on the employer mandate, including the calculation of the penalties, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

To determine whether an employer is an ALE for the year, the general rule is to take the sum of the employer's full-time employees and the number of full-time equivalents (FTEs) for **each month** in the **preceding calendar year** and divide that sum by 12. If the result is 50 or more, the employer is an ALE subject to the employer mandate to provide full-time employees with MEC that meets the minimum value and affordability requirements.

> **Note.** For the definition of FTEs, see IRC §4980H(c)(2)(E). For further details on calculations regarding FTEs and how to calculate whether an employer is an ALE, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update. Also see Treas. Reg. §54.4980H-2.

67. TD 9655, 2014-9 IRB 541.

APPLICABLE LARGE EMPLOYERS[68]

Additional Delayed Implementation

Although the ACA originally indicated that ALEs would first become subject to the employer mandate for 2014, this effective date was **delayed until 2015.**[69]

> **Note.** This delay in the effective date provided relief from **employer penalties** and from the **reporting requirements** for 2014.

IRS Notice 2013-45 provides guidance on the scope of this delay for qualifying employers. Generally, this notice delays implementation of the information reporting requirements under IRC §§6055 and 6056 and any application of penalties under IRC §4980H.

Final regulations allow employers with **50 to 99 full-time employees** (including FTE employees), to be further exempt from the employer mandate penalties until **January 2016.**[70] In addition, employers that have non-calendar-year health plans are exempt from the employer mandate penalties until the **first date of the 2016 plan year.** To qualify for the exemption, the employer with 50 to 99 full-time employees (including FTEs) generally must certify to the IRS that it meets the following criteria.

- The employer employs at least 50 but less than 100 full-time employees (including FTEs) during 2014.
- The employer has not reduced the size of its workforce or its overall hours of service in order to qualify for this exemption.
- The employer has not eliminated or materially reduced any health insurance coverage that is offered from February 9, 2014, through December 31, 2014.

> **Caution.** These criteria are subject to additional specific limitations and definitions. For further details regarding this exemption and the certification requirements, see TD 9655.[71] Workforce-size reductions for genuine business reasons are acceptable, and certain reductions in any existing health care plan may also be allowed without disqualifying the employer from the exemption.

Final regulations indicate that the preceding items must be certified to the IRS on a prescribed form.[72] These forms are explained later.

Adjustment in the §4980H(a) Penalty Calculation

IRC §4980H(a) and Treas. Reg. §54.4980H-4 provide guidance on the penalty calculation for employers that do not offer coverage.

Under the rules of §4980H(a), the penalty calculation permits the employer to subtract **30** full-time employees from the total number of employees upon which the penalty is based. For 2015 only, for employers with 100 or more employees that are subject to the employer mandate, a special relief provision allows the employer to subtract **80** full-time employees from the total number of employees upon which the penalty is based.

68. Treas. Reg. §54.4980H-2.
69. IRS Notice 2013-45, 2013-31 IRB 116.
70. TD 9655, 2014-9 IRB 541.
71. Ibid.
72. TD 9655, 2014-9 IRB 541.

New Employers

An employer **not** in existence on **any day of the prior year** is considered a new employer. A new employer is generally subject to the employer mandate if **both** of the following apply.

- The employer is **reasonably expected** to employ an average of at least 50 full-time employees (measured by counting both full-time employees and FTEs) on business days during the current calendar year.
- The employer **actually employs** at least 50 full-time employees (including any FTEs) on business days during the current calendar year.

However, a new employer can qualify for the transitional relief if it meets the following criteria.

- In 2015, the employer reasonably expects to employ and actually employs less than 100 full-time employees (including FTEs) during its business days.
- The employer meets and certifies the same maintenance of workforce and maintenance of coverage criteria as other employers with 50 to 99 employees (as noted previously) for this transitional relief.

The requirements to maintain workforce and coverage begin on the date within the year that the new employer first came into existence.

Employer Coverage Transition Relief

Generally, an ALE is treated as offering coverage to full-time employees and dependents for a month if the employer offers coverage to **at least 95%** of its full-time employees for that month.[73] An employee is considered to have been offered coverage by the ALE only if the ALE also offers coverage to the employee's dependents.[74] Final regulations provide transitional relief to ALEs in connection with this 95% requirement and for dependent coverage.

For months falling within either the 2015 calendar year or the employer health plan year starting in 2015, the ALE is not subject to a penalty under IRC §4980H(a) if coverage is offered to **at least 70%** (instead of 95%) of its full-time employees.[75]

In addition, for plan years commencing in 2015, the ALE will not be assessed a penalty under IRC §4980H because of a failure to offer coverage for the dependents of full-time employees. Generally, the ALE does not qualify for this relief to the extent that it offered coverage to dependents for a plan year beginning in 2013 or 2014 and reduces or eliminates that dependent coverage. This relief is available for ALEs with plans that:

- Do not provide dependent coverage at all;
- Provide dependent coverage that does not constitute MEC; **or**
- Provide dependent coverage for some, but not all, dependents.

The IRS also provides transitional relief to ALEs that offer health plans with **non-calendar-year plans.**[76] There are three requirements for this transitional relief.

---

73. Treas. Reg. §54.4980H-4(a).

74. Ibid.

75. TD 9655, 2014-9 IRB 541.

76. Ibid.

The IRS provides transitional relief to employers that have plans with a plan year that begins after January 1, 2015. These transitional relief provisions were developed to prevent penalties from being assessed against employers in connection with the period of time between January 1, 2015, and the beginning date for the 2015 plan year. With transitional relief, employers with noncalendar year plans (NCYP) may begin compliance with the employer mandate on the starting date of their plan instead of January 1, 2015. There are three transitional relief rules available[77] for employers with a NCYP. In order to obtain transition relief, an employer with a NCYP must qualify for only one of the following three rules.

1. Employers are not subject to a penalty until the plan year's first day in 2015 with respect to employees who are either enrolled or eligible to enroll in the NCYP as of February 9, 2014 (based on the plan's terms in effect on this date).

2. The employer has a **significant percentage of all employees** either eligible for or covered under a NCYP as of December 27, 2012. To qualify for this relief provision, the employer:

   - Must have at least 25% of its employees covered under the NCYP as of any date in the 12-month period ending February 9, 2014; or

   - Offered coverage under the NCYP to at least one-third of its employees during the most recent open enrollment period that ended before February 9, 2014.

3. The employer has a **significant percentage of full-time employees** eligible for or covered under a NCYP as of December 27, 2012. To qualify for this relief provision, the employer must have:

   - At least one-third of full-time employees covered under the NCYP as of any date in the 12-month period ended February 9, 2014, or

   - Offered coverage to at least 50% of full-time employees during the open enrollment period that ended most recently before February 9, 2014.

Under all three transitional relief provisions, the employer will not be liable for penalties as long as coverage for employees begins on the first day of the plan year.

> **Caution.** Additional requirements apply for ALEs to be exempt from the §4980H penalties under each of the preceding methods of relief.

Definition of Dependent

The proposed regulations used the definition of dependent under IRC §152(f)(1), which is the definition used for purposes of the dependency exemption. This §152 definition includes biological children and also stepchildren, adopted children, and foster children. **However, the final regulations exclude foster children and stepchildren for purposes of the employer mandate rules only.**

> **Note.** The preamble of the final regulations indicate that **foster children** were removed from the definition of dependent at the request of commenters to the proposed regulations because government entities that administer foster children programs typically provide health benefits for foster children under their administration. Also, most **stepchildren** have biological parents, who may be able to provide coverage. It would be unfair to expose the biological parents and the stepparents to penalties for failing to obtain coverage for the stepchild under the individual mandate. In addition, many employer plans do not extend coverage to stepchildren. Accordingly, stepchildren have been removed from the definition of dependent.

77. Ibid.

Special "First Year" Employer Relief

A special 3-month relief period is provided to an ALE during the **first year** in which it is subject to the employer mandate. The ALE is not subject to a penalty in connection with an employee to whom the ALE did not offer coverage as long as coverage is offered on or before April 1 of the year in which it first becomes subject to the employer mandate. However, this relief provision only applies if the employee was not previously offered coverage at any point during the previous year.

Note. For further details on this provision, see Treas. Reg. §54.4980H-2(b)(5).

Special Transition Relief

In addition to other relief provisions that may be available to the employer, transition relief is also provided in connection with the "lookback" period used to determine whether the employer mandate applies. In determining whether it is subject to the employer mandate for **2015,** an employer may use any consecutive 6-month period during **2014.** The employer is only subject to the employer mandate if it employed 50 or more full-time workers (taking into account the number of full-time employees plus FTEs) on business days during the consecutive 6-month period in 2014 that the employer chooses.

Seasonal Worker Exception

If the employer qualifies for the seasonal worker exception, the employer is not subject to the employer mandate. An employer qualifies for this exception if **both** of the following apply.

- The sum of the full-time and FTE employees is greater than 50 for a period of 120 days or fewer during the preceding calendar year.
- Those employees in excess of 50 are seasonal workers.

The definition of seasonal work for purposes of this rule is the definition used under DOL regulations.[78] Generally, seasonal work is defined as labor ordinarily performed during certain seasons or periods of the year which, by its nature, may not be continuous or carried on throughout the year. A worker who moves from one seasonal job to another is still considered a seasonal worker even though that worker may be employed for a major part of the year. Retail holiday season workers are covered under this definition, and an employer with such workers may qualify for this exception if the requirements of the exception are met.

New Employers and the Seasonal Exception. A new employer is an employer that was not in existence for even one day during the previous year. Such an employer is not subject to the employer mandate for the current year if **both** of the following apply.

- The employer reasonably expects that the sum of its full-time employees and FTEs will be greater than 50 for 120 days or fewer during the current calendar year.
- The employees in excess of 50 during that period of 120 days or less will be seasonal workers.

78. 29 CFR §500.20(s)(1).

Special Employee Groups

The final regulations addressed several concerns from commenters regarding how an employer must count hours of service in connection with special groups of employees.

> **Observation.** Under the employer mandate rules, the **hours of service** definition related to employment hours generally includes each hour that the employee works and is compensated and each hour that is compensated for a holiday, vacation, illness, layoff, jury duty, leave of absence, or military leave.

Volunteer Employees. Hours of service from bona fide volunteers **do not count** as hours of service when calculating the number of employees for purposes of the employer mandate. Generally, the definition of bona fide volunteers includes those volunteer employees as defined in IRC §457(e)(11)(B)(i). An employee is a bona fide volunteer employee if both of the following are true.

1. The volunteer employee performs qualified services. **Qualified services** includes firefighting and prevention services, emergency medical services, and ambulance services.
2. The only compensation received by that employee for qualified services is in the form of the following.
   a. Reimbursement for reasonable expenses incurred in the performance of qualified services
   b. A reasonable allowance for expenses incurred in the performance of qualified services
   c. Reasonable benefits and nominal fees (which includes awards for length of service) that are customarily paid by eligible employers for such volunteer services

Under this exemption for volunteer employees, the employer may be a government entity or 501(c)(3) organization.

> **Note.** The final regulations indicate that the reason for this exemption is to encourage volunteer participation.

Student Employees. Final regulations provide an exemption for student employees who are employed in positions subsidized by the federal government through the federal work study program. Accordingly, employers of such students can omit the students' employment hours in determining whether that employer is an ALE. However, students working as **paid interns** or outside of the federal work-study program are **not exempt.**

> **Note.** This exemption was created to ensure that the educational goals of the work-study program would not be adversely affected by the employer mandate rules.

Members of Religious Orders. Final regulations continue to reserve comment on whether the hours of religious order members must be counted by an employer (such as a religious order) for employer mandate purposes. However, the final regulations indicate that until the Treasury Department provides additional specific guidance, a religious order is permitted to exclude the hours worked by a member who has taken a vow of poverty.

Adjunct Faculty. Commenters to the proposed regulations indicated that there are administrative burdens in determining how to count hours for adjunct faculty. Compensation is frequently not based on the actual hours spent both in and out of the classroom for teaching and other duties. In addition, compensation may be based on the credit hours of the courses taught, which is unrelated to the actual hours of work performed. Final regulations indicate that until further guidance is issued regarding adjunct faculty members, the employer **may use any reasonable method** to count the hours of service under the employer mandate rules.

The final regulations indicate that **one reasonable method** is to add 2¼ hours of service for each hour of teaching by the adjunct faculty member. For each hour of actual teaching, this additional 2¼ hours represents the following.

- An additional 1¼ hour for class preparation and grading
- An additional hour for required office hours and attendance at faculty meetings

> **Note.** The final regulations indicate that **this method is not the only reasonable method** and that the employer may use another method that is reasonable until further guidance is issued.

The final regulations indicate that employers may rely on the use of a reasonable method at least through the end of 2015. In addition, in order to ensure employers have time to make the necessary adjustments to implement any new guidance, reasonable-method reliance will not end until January 1 of the calendar year that begins at least six months after the new guidance is issued (and in no event will this be earlier than January 1, 2016).

Layover Hours. Administrative difficulties arise with tracking hours for **layovers** for employees in the airline and other industries. Final regulations indicate that the Treasury Department and IRS are continuing to consider specific rules for these employees, and further guidance will be forthcoming. However, until further guidance is issued, employers must use a **reasonable method** for counting hours of service for these employees. The final regulations provide the following guidance.

- It is **not reasonable** if the employer fails to count layover hours for which the employee receives additional compensation.
- It is reasonable for the employer to treat **each day** the employee is required to be away from home overnight for business purposes as **an 8-hour day** and count such hours under the employer mandate rules.

Example 23. Josephine is an airline service employee who works on domestic flights throughout the United States. She lives in New York City. Her layover hours are not considered by her employer to be hours of service, are not compensated, and are not credited for pension plan or other purposes.

She arrives in Miami on Thursday at 3:00 p.m. and is required to remain in Miami until her next departing flight on Sunday morning at 9:00 a.m. She receives compensation for a full day of work when she is required her work on at least one flight during the day. Accordingly, she receives full compensation for Thursday and for Sunday, the day of the departing flight from Miami.

Even though she is not compensated for the Friday and Saturday layover days, her employer must count these days in order to meet the **reasonable-method** requirement. For employer mandate purposes, her employer must count at least eight hours of service for Friday and eight hours for Saturday (for a total of 16 hours for Josephine's layover time in Miami).

On-Call Hours. On-call hours are hours for which an employee is required to **remain available** for work. Final regulations indicate that the Treasury Department is still developing specific rules to address such on-call hours. Until guidance is issued, employers must use a **reasonable method** to account for these hours, and the final regulations provide the following limited guidance for employers who have on-call employees.

- Failing to count on-call hours that are compensated is not reasonable.
- It is not reasonable if the employer fails to count on-call hours during which the employee is required to remain on the employer's premises or during which there are substantial restrictions preventing the employee from using the time for the employee's own purposes.

> **Observation.** The final regulations require the employer to use a reasonable method until further guidance is issued. Because this remains a gray area, **documenting** the method used by these employers is vital.

OTHER EMPLOYER PROVISIONS UNDER ACA

3

CREDIT FOR SMALL EMPLOYER HEALTH INSURANCE PREMIUMS

Beginning in 2010, certain small employers were eligible to claim a tax credit if they paid at least 50% of the premiums for employee health insurance (not including family or dependent coverage) under a qualified arrangement. The credit is available to small businesses and tax-exempt organizations that employ 25 or fewer FTE who earned average annual wages of $50,000 or less per FTE. The maximum tax credit was 35% of the lesser of the premiums paid or the state average premium for similar coverage. For tax-exempt employers, the maximum tax credit was 25%.[79]

Beginning in 2014, the maximum tax credit increased from 35% to 50% for eligible small business employers. For tax-exempt employers, the maximum credit increased from 25% to 35%. To qualify for this tax credit, the qualified health plan (QHP) must be offered by the employer through a small business health options program (SHOP) exchange. An employer can take this increased credit for two consecutive years beginning with the first year that a SHOP plan is offered.

The online SHOP enrollment process was not implemented at the beginning of 2014. Therefore, transitional relief is available during 2014 to allow eligible employers to enroll in a SHOP plan during 2014 and still qualify for the tax credit for the entire 2014 tax year.[80]

The employer deduction for the payment of health insurance coverage must be reduced by any tax credit claimed.

HEALTH REIMBURSEMENT ARRANGEMENTS

ACA's Impact on HRAs

Prior to the ACA, health reimbursement arrangements (HRA) were used as a tax-free vehicle for employers to reimburse employees for certain health and medical expenses, including health insurance premiums. **After January 1, 2014, HRAs cannot be used to pay for health insurance premiums.**

Effective January 1, 2014, any "account-based" reimbursement plan is considered a group health plan. The healthcare insurance market reform rules of the ACA govern such plans. **The penalty for violating these rules is $100 per day per employee.** Any standalone HRA (not integrated with an ACA-compliant employer-sponsored group health plan) is subject to these rules. If the HRA is integrated with an ACA-compliant employer-sponsored group health plan, then it is deemed in compliance.

Any standalone HRA must only provide for excepted benefits such as accident-only coverage, disability income, certain limited scope dental and vision benefits, certain long-term care benefits, and certain health flexible spending accounts. Any standalone HRA that provides for nonexcepted benefits with an annual limit violates the provisions of the ACA and is subject to the penalty.

79. This is limited to the total amount of federal withholding and Medicare taxes (both employer and employee portions) remitted by the employer during the year.

80. REG-113792-13, 2013-38 IRB 211.

There are two specific ways to integrate an HRA with another group health plan. One integration method is described as **minimum value not required,** and the other is **minimum value required.** Certain requirements must be met for each, as shown in the following table.

	Minimum Value Not Required	Minimum Value Required
Employer	Offers a group health plan (GHP) (other than HRA), and it does not consist solely of excepted benefits	Offers GHP that meets at least the bronze-level plan benefit (minimum value (MV) coverage)
Employee receiving HRA	Enrolled in GHP (other than HRA), and GHP does not consist solely of excepted benefits	Enrolled in an MV GHP that is not an HRA, regardless of whether the employer sponsors an MV GHP
HRA availability	Only available to employees enrolled in non-HRA health plans regardless of whether employer sponsors GHP coverage. (For example, HRA may be offered only to employees who do not enroll in employer-provided GHP but are enrolled in GHPs offered by other groups.)	Only available to those enrolled in MV non-HRA GHPs regardless of whether employer offers MV GHP coverage. (For example, HRA may be offered only to employees who do not enroll in MV employer-provided GHP but are enrolled in MV GHPs offered by other groups.)
Reimbursements limited to	Copays, coinsurance, deductibles, non-HRA premiums, other nonessential health benefits	Not applicable
Opt-out provisions	At least annually	At least annually

Note. For more information on the impact of the ACA on HRAs, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Agricultural Issues and Rural Investments.

INFORMATION REPORTING

On July 24, 2014, the IRS released draft forms that ALEs must use to report **2015 health insurance coverage information** to the IRS and to employees.

Note. Even though ALEs are not required to report **2014 health insurance coverage information** to the IRS or to employees, the IRS is encouraging ALEs to **voluntarily** report the 2014 information. The draft Forms 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns,* and 1095-C, *Employer-Provided Health Insurance Offer and Coverage,* shown later in this section are for **2014 (for voluntary reporting) rather than for 2015 (required reporting).**

3

The IRS will use various information returns to determine whether ALEs are in compliance with the employer mandate to provide affordable health insurance to employees and to determine whether an employee qualifies for a PAC. Following are tables listing the various forms, who issues them, and who receives them.

Form	Issued by
Form 1095-A	The Marketplace (only if Marketplace issued plan)
Form 1095-B	Health insurance providers (issuers)
Form 1095-C	Employers

Size of Employer	Tax Year for Which Form 1095-C Must Be Issued
0–49 full-time employees (including FTEs)	Not applicable
ALEs with 50–99 full-time employees (including FTEs)	2016
ALEs with 100+ full-time employees (including FTEs)	2015

Health Insurance Provider	Forms That Individuals Will Receive		
	Form 1095-A	Form 1095-B	Form 1095-C
Marketplace	X		
Employer		X [a]	X
Private insurance		X	

[a] Self-insured only.

The following is a list of the relevant forms. Draft versions of the forms are shown on subsequent pages.

- **Form 1095-A, *Health Insurance Marketplace Statement.*** This form is issued by the Marketplace. It reports vital information including the monthly premium amount of the second lowest-cost silver plan and the amount of the monthly advance payment of the PAC.

> **Note.** The monthly premium for the second lowest-cost silver plan is used as a benchmark for computing the PAC available to the taxpayer and members of their household.

- **Form 1095-B, *Health Coverage.*** Health insurance providers (issuers), including employers who sponsor self-insured plans, must provide Form 1095-B to covered employees. This form will be used by employees to determine their compliance with the individual mandate on their federal tax returns.
- **Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage.*** This form is provided to **both** the IRS and to employees. ALEs with fully insured plans must complete Parts I and II only. ALEs with **self-insured plans** must complete all three parts. ALEs must furnish this form to full-time and FTE employees by January 31 following the reporting year.
- **Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns.*** ALEs must file Form 1094-C with the IRS by February 28 following the reporting year. If the form is filed electronically, the due date is extended to March 31. This form reports the **total number** of full-time employees including FTEs.

Form **1095-A**

Department of the Treasury
Internal Revenue Service

Health Insurance Marketplace Statement

▶ **Information about Form 1095-A and its separate instructions is at *www.irs.gov/form1095a*.**

☐ CORRECTED

OMB No. XXXX-XXXX

2014

Part I **Recipient Information**

1 Marketplace identifier	**2** Marketplace-assigned policy number	**3** Policy issuer's name	
4 Recipient's name		**5** Recipient's SSN	**6** Recipient's date of birth
7 Recipient's spouse's name		**8** Recipient's spouse's SSN	**9** Recipient's spouse's date of birth
10 Policy start date	**11** Policy termination date	**12** Street address (including apartment no.)	
13 City or town	**14** State or province	**15** Country and ZIP or foreign postal code	

Part II **Coverage Household**

	A. Covered Individual Name	**B.** Covered Individual SSN	**C.** Covered Individual Date of Birth	**D.** Covered Individual Start Date	**E.** Covered Individual Termination Date
16					
17					
18					
19					
20					

Part III **Household Information**

Month	**A.** Monthly Premium Amount	**B.** Monthly Premium Amount of Second Lowest Cost Silver Plan (SLCSP)	**C.** Monthly Advance Payment of Premium Tax Credit
21 January			
22 February			
23 March			
24 April			
25 May			
26 June			
27 July			
28 August			
29 September			
30 October			
31 November			
32 December			
33 **Annual Totals**			

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60703Q Form **1095-A** (2014)

5615

Form **1095-B**

Department of the Treasury
Internal Revenue Service

Health Coverage

▶ **Information about Form 1095-B and its separate instructions is at *www.irs.gov/form1095b*.**

☐ VOID

☐ CORRECTED

OMB No. XXXX-XXXX

2014

DRAFT AS OF
July 24, 2014
DO NOT FILE

Part I **Responsible Individual** (Policy Holder)

1 Name of responsible individual	2 Social security number (SSN)	3 Date of birth (If SSN is not available)
4 Street address (including apartment no.)	5 City or town	
6 State or province	7 Country and ZIP or foreign postal code	
8 Enter letter identifying Origin of the Policy (see instructions for codes): . . . . ▶ ☐	9 Small Business Health Options Program (SHOP) Marketplace identifier, if applicable	

Part II **Employer Sponsored Coverage** (If Line 8 is A or B, complete this part.)

10 Employer name	11 Employer identification number (EIN)
12 Street address (including room or suite no.)	13 City or town
14 State or province	15 Country and ZIP or foreign postal code

Part III **Issuer or Other Coverage Provider**

16 Name	17 Employer identification number (EIN)	18 Contact telephone number	
19 Street address (including room or suite no.)	20 City or town	21 State or province	22 Country and ZIP or foreign postal code

Part IV **Covered Individuals** (Enter the information for each covered individual(s).)

	(a) Name of covered individual(s)	**(b)** SSN	**(c)** DOB (If SSN is not available)	**(d)** Covered all 12 months	**(e)** Months of coverage Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
23				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
24				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
25				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
26				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
27				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
28				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60704B Form **1095-B** (2014)

3

6015

Form **1095-C**
Department of the Treasury
Internal Revenue Service

Employer-Provided Health Insurance Offer and Coverage

▶ **Information about Form 1095-C and its separate instructions is at *www.irs.gov/f1095c*.**

☐ VOID
☐ CORRECTED

OMB No. XXXX-XXXX
2014

DRAFT AS OF July 24, 2014 DO NOT FILE

Part I Employee			**Applicable Large Employer Member (Employer)**		
1 Name of employee		**2** Social security number (SSN)	**7** Name of employer		**8** Employer identification number (EIN)
3 Street address (including apartment no.)			**9** Street address (including room or suite no.)		**10** Contact telephone number
4 City or town	**5** State or province	**6** Country and ZIP or foreign postal code	**11** City or town	**12** State or province	**13** Country and ZIP or foreign postal code

Part II Employee Offer and Coverage

	All 12 Months	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
14 Offer of Coverage (enter required code)													
15 Employee Share of Lowest Cost Monthly Premium, for Self-Only Minimum Value Coverage	$	$	$	$	$	$	$	$	$	$	$	$	$
16 Applicable Section 4980H Safe Harbor (enter code, if applicable)													

Part III Covered Individuals
If Employer provided self-insured coverage, check the box and enter the information for each covered individual. ☐

	(a) Name of covered individual(s)	**(b)** SSN	**(c)** DOB (If SSN is not available)	**(d)** Covered all 12 months	**(e)** Months of Coverage											
					Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
17				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
18				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
19				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
20				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
21				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
22				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60705M Form **1095-C** (2014)

120115

Form **1094-C**

Department of the Treasury
Internal Revenue Service

Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns

▶ Information about Form 1094-C and its separate instructions is at *www.irs.gov/f1094c.*

☐ CORRECTED

OMB No. XXXX-XXXX

2014

DRAFT AS OF July 24, 2014 DO NOT FILE

Part I Applicable Large Employer Member (ALE Member)

1 Name of ALE Member (Employer)		2 Employer identification number (EIN)
3 Street address (including room or suite no.)		
4 City or town	5 State or province	6 Country and ZIP or foreign postal code
7 Name of person to contact		8 Contact telephone number
9 Name of Designated Government Entity (only if applicable)		10 Employer identification number (EIN)
11 Street address (including room or suite no.)		
12 City or town	13 State or province	14 Country and ZIP or foreign postal code
15 Name of person to contact		16 Contact telephone number

For Official Use Only

17 Reserved . . . ☐

18 Total number of Forms 1095-C submitted with this transmittal . . . ▶

Part II ALE Member Information

19 Is this the authoritative transmittal for this ALE Member? If "Yes," check the box and continue. If "No," see instructions . . . ☐

20 Total number of Forms 1095-C filed by and/or on behalf of ALE Member . . . ▶

21 Is ALE Member a member of an Aggregated ALE Group? . . . ☐ **Yes** ☐ **No**
If "No," do not complete Part IV.

22 **Certifications of Eligibility (select all that apply):**

☐ **A.** Qualifying Offer Method ☐ **B.** Qualifying Offer Method Transition Relief ☐ **C.** Section 4980H Transition Relief ☐ **D.** 98% Offer Method

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and to the best of my knowledge and belief, they are true, correct, and complete.

▶ Signature ▶ Title ▶ Date

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 61571A Form **1094-C** (2014)

3

Form 1094-C (2014) 120215 Page **2**

Part III **ALE Member Information—Monthly**

		(a) Minimum Essential Coverage Offer Indicator		(b) Full-Time Employee Count for ALE Member	(c) Total Employee Count for ALE Member	(d) Aggregated Group Indicator	(e) Section 4980H Transition Relief Indicator
		Yes	No				
23	All 12 Months	☐	☐			☐	
24	Jan	☐	☐			☐	
25	Feb	☐	☐			☐	
26	Mar	☐	☐			☐	
27	Apr	☐	☐			☐	
28	May	☐	☐			☐	
29	June	☐	☐			☐	
30	July	☐	☐			☐	
31	Aug	☐	☐			☐	
32	Sept	☐	☐			☐	
33	Oct	☐	☐			☐	
34	Nov	☐	☐			☐	
35	Dec	☐	☐			☐	

DRAFT AS OF July 24, 2014 DO NOT FILE

Form **1094-C** (2014)

120315

Form 1094-C (2014) Page 3

Part IV Other ALE Members of Aggregated ALE Group

Enter the names and EINs of Other ALE Members of the Aggregated ALE Group (who were members at any time during the calendar year).

	Name	EIN		Name	EIN
36			51		
37			52		
38			53		
39			54		
40			55		
41			56		
42			57		
43			58		
44			59		
45			60		
46			61		
47			62		
48			63		
49			64		
50			65		

Form **1094-C** (2014)

NET INVESTMENT INCOME TAX

The following acronyms are used in this section.

- ACB — Adjusted cost basis
- AGI — Adjusted gross income
- FEIE — Foreign earned income exclusion
- FMV — Fair market value
- HoH — Head of household
- MAGI — Modified adjusted gross income
- MFJ — Married filing jointly
- MFS — Married filing separately
- NII — Net investment income
- NIIT — Net investment income tax
- QW — Qualifying widow/widower
- SE — Self employment
- SPA — Significant participation activity

The Health Care and Education Reconciliation Act of 2010[81] created a new Code section: IRC §1411. Under §1411, effective January 1, 2013, a new Medicare tax — the **net investment income tax** (NIIT) — applies to certain types of income received by the taxpayer. In order to understand the scope of the NIIT, it is necessary to have a working knowledge of several definitions and concepts, including the following.

- The types of taxpayers subject to this tax
- The definition of **net investment income (NII)** to which this tax applies
- The important exceptions to the application of this tax

On December 5, 2012, proposed regulations[82] were released providing additional details and guidance regarding many of the key definitions and concepts that define the scope of this new tax. On December 2, 2013, the proposed regulations were finalized[83] with several changes from the original proposed form. In addition, new proposed regulations[84] were released for issues not addressed in the final regulations.

> **Note.** The final and new proposed regulations comprise approximately 400 pages of guidance. This section covers those items that tax practitioners are most likely to encounter when completing tax returns.

---

81. PL 111-152 (Mar. 30, 2010).
82. REG 130507-11, Fed. Reg., Vol. 77, 72612.
83. TD 9644, 2013-51 IRB 676.
84. Ibid.

TAXPAYERS AFFECTED

The 3.8% NIIT applies to three types of taxpayers.[85]

1. Individuals
2. Trusts
3. Estates

Individual Taxpayers

For purposes of the NIIT, an individual generally refers to any **natural person.**[86]

The 3.8% NIIT applies to the **lesser of:**[87]

- The taxpayer's **NII** for the year, **or**
- **MAGI** in excess of the taxpayer's **threshold amount.**

MAGI for purposes of the NIIT is defined as AGI plus the amount of the foreign earned income exclusion (FEIE) less the amount of deductions or exclusions that are omitted from AGI because they were related to FEIE. Usually, MAGI is identical to the taxpayer's AGI.

The taxpayer's **threshold amount** depends on the individual taxpayer's filing status.

> **Observation.** The threshold amounts are **not indexed for inflation** under current tax law.

Filing Status	Threshold Amount
Married Filing Jointly (MFJ), Qualifying Widow(er) (QW)	$250,000
Married Filing Separately (MFS)	125,000
Single, Head of Household (HoH)	200,000

Example 24. Miguel is a single individual with a 2013 MAGI of $150,000, which includes NII of $40,000. The NII includes $20,000 of interest income reported on line 8a of Form 1040, *U.S. Individual Income Tax Return*, and $20,000 of dividend income reported on line 9a.

I. NII for the year		$40,000
II. MAGI in excess of threshold:		
MAGI	$150,000	
Less: applicable threshold for filing status	(200,000)	
MAGI in excess of threshold	$ 0	$ 0
Lesser of I or II:		$ 0

Because the lesser of I or II is $0, the 3.8% NIIT **does not affect** Miguel for 2013.

85. IRC §§1411(a)(1) and (2).

86. Treas. Reg. §1.1411-1(d)(5).

87. IRC §1411(a)(1).

Example 25. Use the same facts as **Example 24,** except Miguel has 2013 MAGI of $210,000.

I. NII for the year		$40,000
II. MAGI in excess of threshold:		
MAGI	$210,000	
Less: applicable threshold for filing status	(200,000)	
MAGI in excess of threshold	$ 10,000	$10,000
Lesser of I or II:		$10,000

Of the $40,000 NII received by Miguel during 2013, only the $10,000 of NII that is over the $200,000 threshold amount is subject to the 3.8% NIIT. Miguel's additional tax liability for the NIIT is $380 ($10,000 × 3.8%). This is reported on Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts,* as follows.

For Example 25

Form **8960**

Department of the Treasury
Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to Form 1040 or Form 1041.

▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

OMB No. 1545-2227

2013

Attachment Sequence No. 72

Name(s) shown on Form 1040 or Form 1041	Your social security number or EIN
Miguel Sanchez	777-77-7777

Part I Investment Income ☐ Section 6013(g) election (see instructions) ☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (Form 1040, line 8a; or Form 1041, line 1)			1	20,000
2	Ordinary dividends (Form 1040, line 9a; or Form 1041, line 2a)			2	20,000
3	Annuities from nonqualified plans (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (Form 1040, line 17; or Form 1041, line 5)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property from Form 1040, combine lines 13 and 14; or from Form 1041, combine lines 4 and 7	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Changes to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	40,000

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a			
b	State income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	0

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-			12	40,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	210,000		
14	Threshold based on filing status (see instructions)	14	200,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	10,000		
16	Enter the smaller of line 12 or line 15			16	10,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). Enter here and on Form 1040, line 60			17	380
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from 18a (see instructions)	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (.038). Enter here and on Form 1041, Schedule G, line 4			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2013)

Example 26. Use the same facts as **Example 24,** except Miguel has 2013 MAGI of $270,000.

I. NII for the year		$40,000
II. MAGI in excess of threshold:		
MAGI	$270,000	
Less: applicable threshold for filing status	(200,000)	
MAGI in excess of threshold	$ 70,000	$70,000
Lesser of I or II:		$40,000

Even though Miguel has $70,000 of income above his $200,000 threshold, the 3.8% NIIT only applies to Miguel's NII and not to other types of income. Because all of Miguel's NII exceeds his $200,000 threshold, he is subject to NIIT on the entire $40,000 of NII. His total 2013 NIIT liability is $1,520 ($40,000 × 3.8%).

Observation. Taxpayers with MAGI under the threshold amounts are not subject to NIIT. Taxpayers with no NII are also not subject to NIIT.

Exempt Individuals. Although the NIIT generally applies to all natural persons, it does not apply to nonresident aliens.[88] A nonresident alien is an individual who is neither a citizen nor a resident of the United States.[89]

A U.S. citizen married to a nonresident alien is generally treated as a MFS taxpayer.[90] The income of the spouse who is a U.S. citizen or resident is subject to the NIIT, and the MFS threshold of $125,000 applies to that income under the NIIT rules. The income of the nonresident alien spouse is not subject to the NIIT. However, both spouses may make a special election to file a joint return. If this election is made, the nonresident alien spouse is treated as a U.S. resident for tax purposes.[91] All income on the joint return, including that of the nonresident alien spouse, is subject to the NIIT rules for a couple making this election.

Note. For more details and guidance on this joint election, see Treas. Reg. §§1.6013-6 and 1.6013-7.

Estates and Trusts

The NIIT may affect the tax liability of estates and trusts. Form 1041, *U.S. Income Tax Return for Estates and Trusts,* is used by estates and certain trusts to report their income and expenses. If an estate or trust is subject to tax under the Code, then that estate or trust is also subject to the NIIT rules. The following types of income earned by an estate or trust are subject to income tax.[92]

- Income accumulated in trust for the benefit of unborn or unascertained persons
- Income accumulated in trust for the benefit of a person's contingent interests
- Income accumulated in trust or an estate and held for future disposition
- Income to be distributed to beneficiaries
- Income that is held by a guardian for later distribution under a court order
- Income received by a decedent's estate during the administration or settlement period of the estate
- Income that can be distributed under the discretion of the trustee

88. Treas. Reg. §1.1411-2(a)(1).
89. IRC §7701(b)(1)(B).
90. IRC §6013(a)(1).
91. Treas. Reg. §1.6013-6(a)(1).
92. IRC §641(a).

Trusts and estates are allowed to deduct **income distributions** to the beneficiaries.[93] Therefore, in most cases, distributed income and income that was required to be distributed is not subject to income tax or the NIIT.

Generally, the typical **ordinary trust** arrangement that is subject to income tax is one in which property is given to one or more trustees who are responsible for the protection of the property and for managing or conserving the property for beneficiaries.[94] However, if a trust arrangement has a business purpose or has trustees and beneficiaries that use the trust arrangement for profit-making purposes, the arrangement is not considered an ordinary trust subject to the trust income tax rules. Instead, it is classified as a **business entity** under the "check-the-box" rules and is typically taxed as either a corporation or partnership. The fact that the beneficiaries did not provide the trustee or trustees with the trust property is not sufficient by itself to categorize the trust as an ordinary trust rather than a business-purpose trust.

An **investment trust** with multiple classes of ownership interests ordinarily is classified as a business entity. This is not true if there is no power under the trust agreement to vary the investment of the certificate holders. The trust may be classified as an ordinary trust if it is formed to facilitate direct investment in the assets of the trust and when the existence of multiple classes of ownership interests is incidental to that purpose.

> **Note.** For more information on whether a trust arrangement is properly classified as an ordinary trust subject to income tax and the NIIT or, alternatively, is classified as a business or investment trust, see Treas. Reg. §301.7701-4.

Each year, trusts and estates are liable for the 3.8% NIIT on the **lesser of:**[95]

- The trust's **undistributed** NII for the year, **or**
- The **excess** (if any) of the trust's AGI over the dollar amount at which the highest tax bracket for estates and trusts begins **($12,150 for 2014).**[96]

Undistributed NII for the trust or estate is calculated by first determining the NII of the trust.

> **Note.** The amount of NII for a trust or estate is generally calculated in the same way as NII for individuals. The applicable rules for determining the amount of NII for an individual, trust, or estate are discussed later.

The NII for an estate or trust is based on all the NII amounts that the trust **received** during the year.[97] After the amount of the estate's or trust's NII that was received is determined, the undistributed NII is calculated using the following general formula.

Trust or estate NII
– Amount allowed as a deduction under trust tax law for distributions of net income made to beneficiaries
– Amount of deduction allowed under trust tax law for any amounts permanently paid or set aside for charitable contributions
______
Undistributed NII subject to NIIT

93. IRC §§651 and 661.
94. Treas. Reg. §301.7701-4(a).
95. IRC §1411(a)(2).
96. 2014 Form 1041-ES, *Estimated Income Tax for Estates and Trusts*.
97. Treas. Reg. §1.1411-3(e).

The NII that the trust distributes to beneficiaries retains its character as NII and forms part of the NII of each beneficiary for the tax year.

> **Note.** Trust tax rules are complex. For guidance on the amounts allowed as a deduction for distributions to beneficiaries, see the 2010 *University of Illinois Federal Tax Workbook,* Chapter 7: Estate and Trust Taxation. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

Exempt Trusts. The proposed regulations specifically exempt certain trusts and estates from the NIIT, including the following.

- A trust (or portion of a trust) that is treated as a **grantor trust**

> **Note.** A **grantor trust** is generally a trust established by a taxpayer who does not relinquish full control over the trust property. Such a trust is usually not recognized as a separate taxable entity. All grantor trust income and deductions are treated as directly belonging to the grantor. The grantor is generally subject to the NIIT instead of the grantor trust. IRC §§671–678 address grantor trusts.

- Trusts established exclusively for religious, charitable, scientific, literary, or educational purposes, or to prevent cruelty to children or animals
- Trusts formed to foster national or international amateur sports (without the provision of athletic facilities or equipment)
- Tax-exempt trusts under IRC §501 (includes trusts organized as civic leagues, social welfare organizations, chambers of commerce, and social or recreation clubs)
- Charitable remainder trusts (However, such trusts' beneficiaries are subject to the NIIT rules.)
- Any other trusts, funds, or accounts that are statutorily tax-exempt, such as an Archer medical savings account, a health savings account, a §529 qualified tuition program, or a Coverdell education savings account
- Foreign trusts and estates (However, such trusts' U.S. beneficiaries are subject to the NIIT rules.)[98]

Other Special Trusts. The following table shows where to find guidance on the NIIT rules for certain special trusts.

Type of Trust	Further Guidance
Electing small business trust (ESBT)	Treas. Reg. §1.1411-3(c)
Charitable remainder trust	Treas. Reg. §1.1411-3(d)
Bankruptcy estate [a]	Treas. Reg. §§1.1411-2(a)(2)(v) and (d)(1)(ii) Treas. Reg. §1.1411-3(b)(2)(ii)

[a] If the debtor is an individual, the bankruptcy estate is subject to NIIT. The applicable threshold is the same as for an MFS taxpayer ($125,000).

98. Treas. Reg. §§1.1411-3(b)(viii) and (ix). Foreign trusts are defined in IRC §7701(a)(31)(B).

NET INVESTMENT INCOME

Calculating NII accurately for individuals, trusts, and estates that are subject to the NIIT rules is essential because the amount of NII for the year determines:

- Whether that individual, trust, or estate will have NIIT liability for the year; and
- The NIIT liability amount, using the 3.8% rate.

NII includes some forms of **income** and **capital gains** the taxpayer receives during the year. However, not all income or capital gains become part of NII for the taxpayer. Both the **income** and **capital gain** components have some exceptions that are not subject to the 3.8% NIIT.

Generally, **NII includes** the following types of income.[99] These categories are referred to as the **three IRC §1411(c) categories** throughout the rest of this section.

1. Gross interest, dividends, nonqualified annuity distributions, royalties, rents, and substitute interest or dividends, **except** to the extent excluded by the business exception (The business exception applies if this is the type of income that the business was originally established to earn.)[100]

> **Note.** Annuity distributions subject to NIIT should be identified with the **special distribution code "D" in box 7 of Form 1099-R.** Code D indicates distributions from nonqualified annuities (often referred to as self-invested annuities) and certain life insurance contracts. **In most cases, the taxable distribution shown in box 2a of the Form 1099-R is reported on Form 8960, line 3.**

2. Income from a passive activity[101] or from a **covered trade or business,** meaning a trade or business that trades in financial instruments or commodities[102]

3. Net capital gains attributable to the disposition of property **other than property held in a trade or business** (Only net gains included in taxable income are subject to the NIIT.)[103]

> **Note.** "Trade or business" as used in IRC §162 relates to the deduction of ordinary and necessary expenses. Neither the Code nor regulations provide a clear definition of trade or business.

---

99. IRC §§1411(c)(1) and (2).

100. Temp. Treas. Reg. §1.469-2T(c)(3)(ii); and Treas. Reg. §1.1411-4(b)(3), Example 4.

101. Within the meaning of IRC §469.

102. As defined in IRC §475(e)(2).

103. IRC §1411(c)(1)(A)(iii).

Some common forms of income that are **not included** in NII include the following.[104]

- Wages
- Unemployment benefits
- Net operating income from a nonpassive business
- Social security benefits
- Alimony
- Tax-exempt interest
- Self-employment (SE) income[105]
- Qualified plan distributions (IRC §§401(a), 403(a), 403(b), 408, 408A, 457(b))[106]

Note. Income that is not subject to the NIIT may be subject to the additional Medicare tax, which is discussed later.

Example 27. Gyp DeCarlo is licensed in the state of New Jersey to make loans. He materially participates in the business. In 2014, he earns $135,000 in interest income from loans made to customers. The $135,000 of interest income is **not** NII for 2014. Even though it is interest income, it is earned in the ordinary course of a business formed to make loans. In addition, his participation is not passive, and the business is not one of the covered trades or businesses.

Example 28. Use the same facts as **Example 27,** except Gyp is a licensed commodities broker. The commodity brokerage activity generates revenue of $135,000 for 2014. Because Gyp's business is a covered business, the entire $135,000 constitutes NII.

Example 29. Brenda is a licensed bricklayer. She is the sole owner of an S corporation through which she conducts her business on a full-time basis. As such, she materially participates in the business for 2014.

In 2014, the S corporation reported $135,000 of ordinary income. This amount passes through to Brenda and is reported on her 2014 Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc*.

Because the $135,000 is net operating income from a **nonpassive activity** and the activity is **not** one of the covered trades or businesses, **it is not subject to NIIT.**

Example 30. Dr. Everson is employed in a family medical practice by an unrelated corporation. In addition, she has a public speaking business and owns a laboratory. Both are operated as sole proprietorships. She spends only 90 hours on her public speaking business during 2014.

Because Dr. Everson does not meet the material participation requirement for her speaking business, the net income from it is generally considered passive. However, because she operates the speaking business as a sole proprietorship, subject to SE tax, the net income from it is exempt from NIIT.

---

104. *Questions and Answers on the Net Investment Income Tax.* March 5, 2014. [www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs] Accessed on Jun. 29, 2014.

105. IRC §1411(c)(6).

106. IRC §1411(c)(5).

Income Attributable to Working Capital

Income or gain earned on the **working capital of a business** is treated as **not** derived in the ordinary course of a trade or business[107] and **is consequently considered NII.** The regulations define income from working capital by what it is not. The following income is **not attributable to working capital** if received in the **ordinary course** of a trade or business.[108]

- Interest income from loans made while in the business of lending money
- Interest on accounts receivable under credit terms comparable to the taxpayer's normal business practices
- Income from investments if the taxpayer is in the business of providing insurance or annuities
- Income or gain from property if the taxpayer is in the business of selling such property (However, if the property sold was held for investment at any time before it was sold, the sale is considered outside the ordinary course of the business.)
- Royalties earned by a business that licenses intangible property, but only if the taxpayer created the property or, in the process of developing or marketing the intangible property, the taxpayer performed substantial services or incurred substantial costs[109]
- Other income that is identified by the IRS as being from a trade or business

Working capital is generally:

- The average daily balance of the business's operating or other checking account(s), and
- Amounts set aside for which there is no current need or use.[110]

Example 31. Orazio owns O's Collision Shop, Inc., an S corporation. His full-time activity is **nonpassive under the §469 rules,** and the business constitutes a trade or business under §162.

The business checking account is maintained at the local bank and is an interest-bearing account. Orazio pays all the ordinary and necessary expenses of the collision shop with the cash flow that the shop generates. He deposits the gross income of the business into this account and pays the recurring expenses from it. The 2014 average daily balance is $4,000 (though at times it may be significantly higher or lower).

Orazio also keeps $50,000 in a business money market account. This account serves as a cushion to alleviate periods of negative cash flow and to fund equipment purchases.

In 2014, Orazio earned $6,000 in interest income on the checking and money market accounts. The funds held in these accounts are considered working capital. The 2014 interest of $6,000 is considered NII and is subject to the 3.8% NIIT if Orazio's income exceeds his threshold amount.

Passive Activities Subject to NIIT

Whether the taxpayer's activity is passive is generally determined at the individual taxpayer level.[111] Under the passive activity rules, there are **four ways** for an item of income to be **nonpassive.**[112]

1. Grouping
2. Activity recharacterization
3. Income recharacterization
4. Material participation

---

107. Treas. Reg. §1.1411-6(a).
108. Temp. Treas. Reg. §1.469-2T(c)(3)(ii).
109. Temp. Treas. Reg. §§1.469-2T(c)(3)(ii)(E), (c)(3)(iii)(B).
110. Treas. Reg. §1.1411-6(b)(1).
111. Treas. Reg. §1.1411-5(b)(ii).
112. TD 9644, Federal Register, Vol. 78, No. 231, 72411, Preamble Part 5(E) 72411

The **recharacterization exceptions** under the passive activity rules apply when determining whether income is subject to NIIT, **except** when the income is also characterized as portfolio income under the passive activity regulations.[113]

For the **material participation exception,** the NIIT rules use the same material participation rules as IRC §469 and the related regulations.[114] These material participation rules are used to determine whether a taxpayer has passive losses subject to passive activity loss limitations.

> **Note.** Recharacterization rules applicable to rental activities are discussed later. For further details on the material participation rules, including examples, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

Grouping Activities under §469. Categorizing income as passive or nonpassive is necessary before applying the NII rules. Income that would otherwise be passive but is categorized as nonpassive because of the way the taxpayer grouped the activities is **not** considered part of the taxpayer's NII. However, to be excluded, the income must be earned in the ordinary course of a trade or business and that business must not be a covered business.

If the taxpayer engages in two or more activities in which the taxpayer's activity does not meet any of the material participation tests,[115] those activities may be grouped and considered as a single activity that together can meet one of the material participation tests. In order to be grouped, the activities must constitute an appropriate economic unit.[116]

Example 32. Use the facts from **Example 30,** except Dr. Everson operates the public speaking business through an S corporation. In 2014, She spends only 90 hours on her public speaking business.

The laboratory is operated as a sole proprietorship. Her lab provides test results for her patients and for patients of other physicians. Dr. Everson spends 510 hours in 2014 on her lab business duties.

Because Dr. Everson does not meet the material participation requirement for her speaking business, the net income from it is generally considered passive. She meets the material participation requirement for her laboratory business.

Under the rules of IRC §469, Dr. Everson can group the two businesses in order to meet the material participation requirement for **both** of them if the two activities constitute an appropriate economic unit.

If she elects to group the two businesses as a single activity, the net profit from the speaking business is considered nonpassive. Under the NII rules, if the speaking activity is a nonpassive business and it is not a covered business, the income is **not** considered NII. Consequently, it is **not** subject to the 3.8% NIIT.

> **Note.** For further details on grouping activities, including the appropriate economic unit requirement, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

A taxpayer that becomes subject to the NIIT may, **on a one-time basis,** regroup activities without regard to the manner in which activities were grouped in prior tax years.[117] However, the taxpayer is only eligible to use this special one-time (fresh-start) regrouping opportunity for the **first year** in which the taxpayer becomes subject to NIIT liability.

> **Note.** Any regrouping of activities under this one-time regrouping rule is subject to the appropriate economic unit grouping requirement and disclosure requirements under IRC §469, Treas. Reg. §1.469-4(e), and Rev. Proc. 2010-13.

---

113. Treas. Reg. §1.1411-5(b)(2).
114. Ibid.
115. Temp. Treas. Reg. §1.469-5T.
116. As defined by Treas. Reg. §1.469-4(c).
117. Treas. Reg. §1.469-11(b)(3)(iv).

Amendments Affecting Regrouping Elections. While amending a return, a taxpayer may discover that the amendment causes them to be liable for the NIIT for the first time. This makes them eligible for regrouping, and they may now regroup activities.

If a taxpayer has already used the one-time regrouping rule and amends a return for a tax year that is prior to the year in which the regrouping rule was used, the amended return **must** reflect the regrouped activities. If the amended return does not reflect the activities as regrouped, the regrouping is deemed invalid. However, the regrouping is not invalid if the taxpayer can establish under §469 that there was a material change in facts and circumstances that support maintaining the regrouping in the year in which the activities were regrouped.

If the taxpayer discovers that they were not eligible to regroup because the amended return shows that the taxpayer is not subject to the NIIT for that year, the regrouping is deemed to have **no effect** for that year or subsequent years. Any appropriate amended returns should be filed to reflect these changes for the subsequent affected years.

Observation. Because the regrouping regulations related to NIIT became effective on January 1, 2014, for the 2014 tax year and subsequent years, the first possible year for which a taxpayer may become eligible for regrouping is generally the 2014 tax year. However, the regrouping rule may be used for any taxable year that begins during 2013 as long as the eligibility requirement is met.

Example 33. Neil, a single filer, has the following four activities in which he does **not** materially participate.

1. Bicycle rental shop
2. Bicycle retail shop
3. Sports photography studio
4. Bicycling and sports event planning service

Through 2014, for purposes of the passive activity rules, Neil has grouped the bicycle rental and retail shop activities as a single activity. The photography studio and bicycling and sports event planning service are treated as separate activities.

In 2015, Neil has MAGI of $210,000 and NII of $1,000. This is the **first year** in which Neil is subject to the NIIT. His accountant, Virgil, recommends that Neil use the **one-time regrouping rule** and regroup all four activities into a single group. It is determined that all four activities meet the appropriate economic unit requirement, and Virgil completes Neil's 2015 tax return to reflect a single grouping for all four activities.

In June 2016, however, Neil's employer amends Neil's 2015 Form W-2, *Wage and Tax Statement,* to correct overstated wages of $15,000. Virgil amends Neil's 2015 tax return to reduce Neil's wages by $15,000.

As a result, Neil is **not** subject to the NIIT for 2015, because the amended return reduces his 2015 MAGI below the NIIT filing threshold for his filing status. Accordingly, the one-time regrouping of the four activities for 2015 is no longer effective. The original grouping of the activities that was used through 2014 continues to be effective for 2015. On Neil's 2015 amended return, Virgil must adjust all applicable items to reflect the original grouping in effect prior to the 2015 regrouping.

However, if Neil can establish that there is a material change in circumstances that would support the regrouping in 2015, he may use that new grouping.

Note. For further details in connection with the special one-time regrouping rule, including details regarding the effect of amended returns, see Treas. Reg. §1.469-11(b)(3)(iv).

GENERAL CALCULATION RULES FOR NII

Generally, the rules that determine the amount and character of income for income tax purposes also apply to determine the amount of NII each year.[118] Any income received by the taxpayer that falls into one of the three IRC §1411(c) categories constitutes **gross investment income.** However, the taxpayer's gross investment income for the year is reduced by **deductions properly allocable** to those sources of income before determining NII subject to the NIIT.[119]

Deductions that are properly allocable to gross investment income[120] include the following.

- Deductions allowed under IRC §62 in determining the net income from rental activities, royalties, trades, and businesses when those activities are included in one of the three IRC §1411(c) categories
- Deductions for penalties on early withdrawals of savings
- Net operating losses from activities included in one of the three IRC §1411(c) categories[121]
- Certain itemized deductions allowed under IRC §63(d) (discussed later)
- Loss deductions allowed under IRC §165, which include capital losses and casualty losses (discussed later)
- Ordinary loss deductions for debt instruments under Treas. Reg. §§1.1275-4(b) or 7(f)(1)
- Other deductions allowed by the Code that are properly allocable to gross NII

Note. Further information on the deductions allowed to reduce NII can be found in Treas. Reg. §1411-4(f). The Treasury Department may announce other allowable deductions in the future.

Generally, if the amount of properly allocable deductions claimed by the taxpayer exceed the gross income and net gain taken into account in the three IRC §1411(c) categories, the excess loss cannot be taken into account in **any other tax year,** except as allowed under the rules for the particular deduction when used for general income tax purposes.

In addition, any properly allocable expense that is subject to the 2%-of-AGI floor or the income-based phaseout must be subjected to such limit before arriving at the amount that is deductible against NII.

When a properly allocable deduction is allocable to both NII and income that is excluded from NII, the taxpayer is permitted to use **any reasonable method** to calculate the amount of that deduction that is properly allocable to NII.

Deductions Allowed under IRC §62[122]

Deductions allowed under IRC §62 include trade or business deductions attributable to a **passive** activity or a **covered trade or business** interest subject to the NIIT. **However, deductions that were claimed against SE income are specifically excluded from the calculation of NII on Form 8960.**

Example 34. Use the facts from **Example 30.** The expenses that Dr. Everson deducts on her public speaking business Schedule C, *Profit or Loss from Business*, are omitted in Part II of Form 8960. This is because the net income from the public speaking business is subject to SE tax, and therefore, the Schedule C gross income is not included in Part I of Form 8960.

118. Treas. Reg. §1.1411-1(a).

119. IRC §1411(c)(1).

120. Treas. Reg. §1.1411-4(f).

121. See Treas. Reg. §1.1411-4(h) for more information on allocating net operating losses among activities.

122. Treas. Reg. §1.1411-4(f)(2).

Example 35. Gordon owns an S corporation interest in a sawmill business. Because Gordon does **not** materially participate in the business, it is a passive activity.

Gordon's 2013 pro-rata share of the S corporation's operating income is $35,000 and represents passive income. The sawmill incurs operating expenses that are deductible under IRC §§62 and 162 as ordinary and necessary expenses. Gordon's share of these expenses, which is $22,000, includes items such as rent, utilities, employee wages, and payroll taxes.

The $35,000 of passive income is included in Part I of Gordon's 2013 Form 8960, line 4a. His share of the sawmill operating expenses of $22,000 is properly allocable to that income. They are deducted in Part II of his 2013 Form 8960, line 10. Therefore, $13,000 ($35,000 – $22,000) is included with any other 2013 NII that Gordon receives.

Note. Generally, only the net income from these type of activities is included in AGI. Consequently, only the net income is shown on Form 8960.

Form **8960**

Department of the Treasury
Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to Form 1040 or Form 1041.

▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

OMB No. 1545-2227

2013

Attachment Sequence No. **72**

Name(s) shown on Form 1040 or Form 1041: **Gordon**

Your social security number or EIN: **123-45-6789**

Part I Investment Income ☐ Section 6013(g) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (Form 1040, line 8a; or Form 1041, line 1)			1	
2	Ordinary dividends (Form 1040, line 9a; or Form 1041, line 2a)			2	
3	Annuities from nonqualified plans (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (Form 1040, line 17; or Form 1041, line 5)	4a	35,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	35,000
5a	Net gain or loss from disposition of property from Form 1040, combine lines 13 and 14; or from Form 1041, combine lines 4 and 7	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Changes to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	35,000

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a			
b	State income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	22,000
11	Total deductions and modifications. Add lines 9d and 10			11	22,000

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-	12	13,000

The deduction of expenses attributable to a taxpayer's interest in a passive trade or business may be complex because of other passive activity tax rules under §469. The following example illustrates various passive activity limitations and the effect on the computation of NIIT.

Example 36. Lara, a single taxpayer, owns a 60% partnership interest in a business. Because Lara is merely an investor, her partnership interest is a passive activity. It is her only passive activity. For 2013, the following data reflects her passive partnership interest.

Gross operating income	$37,000
Operating deductions	60,000
Basis in partnership interest	50,000
At-risk amount in partnership	8,000

For 2013, Lara's share of the partnership loss is $23,000 ($37,000 gross operating income – $60,000 of operating deductions). In calculating Lara's NII for 2013, the $37,000 of gross operating income from the passive partnership interest constitutes gross investment income under IRC §1411(c).

To determine the allowable amount of deductible expenses that Lara can use to offset the $37,000 income under the NIIT rules, she must first determine the allowable portion of the $23,000 partnership loss. Lara has three possible limits in deducting the $23,000 loss on her 2013 tax return. The three limits apply in the following order.

1. Her basis in the partnership interest
2. Her at-risk amount
3. Her deductible loss amount under the passive activity loss limitation

Note. For more information on these limits and how they apply to the deduction of losses, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

First, Lara's $50,000 partnership **basis** is higher than the $23,000 loss. Therefore, her loss deduction is **not** limited by basis.

Second, because of Lara's $8,000 at-risk amount, her $23,000 loss is limited to $8,000 under the **at-risk limitation.** The remaining $15,000 of her 2013 partnership loss is suspended.

Third, under the **passive activity loss limit**, Lara's passive activity deductions are limited to her passive activity income. Because this partnership interest is her only 2013 passive activity, she has no 2013 passive activity income to offset the remaining $8,000 loss after the at-risk limitation is applied. The passive activity loss limitation therefore limits Lara's 2013 passive loss deduction to $0.

Of the three applicable limits, the passive loss limit serves to limit Lara's deductions to the lowest amount. Although Lara's Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* shows the $23,000 loss on line 1, none of the loss is reported on her Schedule E, *Supplemental Income and Loss*. Line 17 of her 2013 Form 1040 is $0. Therefore, line 4a of her 2013 Form 8960 is also $0.[123]

123. Based on Treas. Reg. §1.1411-4(f)(2)(v), Example 1.

Certain Itemized Deductions under IRC §63(d)[124]

To the extent that the following itemized deductions relate to NII, these Schedule A deductions may be allocated and deducted against NII in Part II of Form 8960.

- Investment interest expense
- Investment advisory and brokerage fees
- State and local income taxes
- Deductions for estate and generation-skipping transfer taxes
- Ordinary and necessary expenses paid in connection with the determination, collection, or refund of any tax
- Amortizable bond premiums paid on taxable bonds[125]
- For estate and trusts, fiduciary fees allocable to NII

Example 37. In 2013, Georgia borrows money to purchase shares of common stock in Lucid Investcorp, Inc. During 2013, she pays $3,700 in interest on the investment loan. Under the rules for the investment interest deduction, this $3,700 of interest is allocable to the stock that Georgia purchased. She has no carryforward of investment interest expense from prior years.

In 2013, Georgia has $4,000 of taxable interest and $2,000 of ordinary dividends. She can deduct the full $3,700 investment interest expense in 2013 both on Schedule A (for income tax purposes) and on Form 8960 (for NIIT purposes).

Form **8960** — Department of the Treasury, Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to Form 1040 or Form 1041.

▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

OMB No. 1545-2227 — 2013 — Attachment Sequence No. 72

Name(s) shown on Form 1040 or Form 1041: **Georgia** — Your social security number or EIN: **333-33-3333**

Part I Investment Income ☐ Section 6013(g) election (see instructions) ☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (Form 1040, line 8a; or Form 1041, line 1)			1	4,000
2	Ordinary dividends (Form 1040, line 9a; or Form 1041, line 2a)			2	2,000
3	Annuities from nonqualified plans (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (Form 1040, line 17; or Form 1041, line 5)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property from Form 1040, combine lines 13 and 14; or from Form 1041, combine lines 4 and 7	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Changes to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	6,000

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a	3,700		
b	State income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	3,700
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	3,700

Tax Computation

124. Treas. Reg. §1411-4(f)(3).

125. See Temp. Treas. Reg. §1.171-2T(a)(4)(i)(C) for an example.

Generally, investment interest is deductible only to the extent of investment income. Any investment interest in excess of investment income for the year is carried forward for use in later years. These same rules apply for NIIT purposes.

Note. For additional details on the investment interest deduction, see IRS Pub. 550, *Investment Income and Expenses,* and the instructions for Form 4952, *Investment Interest Expense Deduction.*

Example 38. Use the same facts as **Example 37,** except Georgia has no investment income in 2013. Because she has no investment income, she cannot deduct any of her $3,700 of investment interest. Even if she has other types of NII, such as rental income, she cannot deduct the investment interest expense in calculating her NIIT.

The $3,700 of interest expense carries forward to 2014 under the investment interest deduction rules. If Georgia has any investment income in 2014, she may deduct the carryforward amount against this income for both income tax and NIIT purposes.

Note. Certain itemized deductions that are properly allocable to NII are subjected to the 2%-of-AGI limitation first. The resulting amount is the deductible amount that may be used to offset NII for the year.

Loss Deductions under IRC §165[126]

IRC §165 allows a deduction for various losses, including capital losses, theft losses, gambling losses, casualty losses, and disaster losses. In general, if the losses are allowed for income tax purposes, they are also allowed for NIIT purposes if income of the same nature is included in NII.

According to the regulations, losses must be allocated to NII by applying the following tests.[127]

1. IRC §165 losses can be deducted from NII to the extent they exceed the amount of taxpayer's gains included in gross income derived from dealings in properties.[128]
2. These losses can be deducted from NII if they are not taken into account in determining any net gains that are included in NII for the year under the third of the IRC §1411(c) categories (the "net gain" category).

These tests appear confusing. However, upon examination of the examples in the regulations, the purpose of the tests is to apply losses first against any gains included in NII and then to any other NII.

Example 39. Thurman has no capital loss carryovers to 2013. However, for 2013, he has the following items that must be reported on his 2013 tax return.

Type of Income	Amount	Included in AGI	Included in NII
Wages	$200,000	$200,000	$ 0
Interest income	60,000	60,000	60,000
§1231 gain on sale of vacant lot used in his sole proprietorship	35,000	35,000	0
Short-term capital loss on sale of GM shares	(20,000)	(20,000)	(20,000)
Total		$275,000	$40,000

For 2013 income tax purposes, Thurman reports his $60,000 of interest income for both income tax (on Schedule B) and NIIT (on line 1 of Form 8960) purposes.

126. IRC §165(f).

127. Treas. Reg. §1.1411-4(f)(4).

128. Under IRC §61(a)(3).

Thurman's long-term gain of $35,000 resulted from the sale of a vacant lot used by his sole proprietorship in which he materially participates. This income is not included in NII because it is from a nonpassive activity. It is a long-term gain for income tax purposes.

The $20,000 short-term capital loss is allowed for income tax purposes to offset the $35,000 long-term §1231 gain. A $15,000 ($35,000 – $20,000) net capital gain is included in Thurman's 2013 AGI.

Because the full $20,000 short-term loss is not limited for income tax purposes, it is allowed in full for NIIT purposes. This is true even though the §1231 gain that allows the loss to be deducted in full is not included in 2013 NII.

Thurman has no gains from dealings in properties and no capital gains in the §1411(c) categories. Therefore, he meets both tests to deduct the $20,000 for NII purposes. For purposes of test 1, the amount of loss in excess of gains from dealings in properties is $20,000; for purposes of test 2, none of the loss was taken into account in determining category 3 net gains. Therefore, the entire $20,000 short-term loss is deductible for NIIT purposes.

Example 40. Use the same facts as **Example 39,** except Thurman did not sell the lot. His 2013 tax return now reflects the following.

Type of Income	Amount	Included in AGI	Included in NII
Wages	$200,000	$200,000	$ 0
Interest income	60,000	60,000	60,000
Short-term capital loss on sale of GM shares	(20,000)	(3,000)	(3,000)
Total		$257,000	$57,000

Because Thurman's $20,000 capital loss deduction was limited to the allowable maximum of $3,000 for AGI purposes, it is also limited in the computation of NII. The $3,000 is not used to offset any gains included in tests 1 and 2 and therefore is allowed against NII. The $17,000 ($20,000 – $3,000) short-term capital loss carryforward is allowed against future income for purposes of both income tax and NIIT.[129]

Form **8960** — **Net Investment Income Tax— Individuals, Estates, and Trusts** — OMB No. 1545-2227 — **2013**

Department of the Treasury Internal Revenue Service (99)

▶ Attach to Form 1040 or Form 1041.

▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

Attachment Sequence No. **72**

Name(s) shown on Form 1040 or Form 1041: **Thurman** — **Your social security number or EIN**: **111-11-1111**

Part I Investment Income ☐ Section 6013(g) election (see instructions) ☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (Form 1040, line 8a; or Form 1041, line 1)			1	60,000
2	Ordinary dividends (Form 1040, line 9a; or Form 1041, line 2a)			2	
3	Annuities from nonqualified plans (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (Form 1040, line 17; or Form 1041, line 5)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property from Form 1040, combine lines 13 and 14; or from Form 1041, combine lines 4 and 7	5a	(3,000)		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	(3,000)
6	Changes to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	57,000

[129] Treas. Reg. §1.1411-4(f)(4)(ii), Example 2.

SPECIAL ISSUES RELATED TO RENTAL INCOME AND NIIT

The Treasury regulations covering what types of rental income are includible in a taxpayer's NII are **complex. The NII rules largely depend on the IRC §469 passive activity rules** to determine whether the income is generally **active (and excludible** from NII if the business exception factors are met) or **passive (and includible** in NII).

However, the IRS indicated that for purposes of the NIIT rules, it will **not** rely solely on how income is characterized under IRC §469.[130] This is because the **definition of passive activity under IRC §469 is broader than the definition under IRC §1411 for NIIT purposes.**[131]

To address situations specific to determining NII, the final Treasury regulations include specific rules for certain rental activities, including self-rentals and real estate professionals who receive rental income. Some of these special rules are covered in this section.

> **Note.** For reference, the guidance associated with rental income and NII is found in IRC §469 and Treas. Reg. §§1.1411-4(g)(6) and (7). The preamble to the final NII regulations found in TD 9644 also provides helpful guidance.

Rental Activities Passive Activity Exceptions

Generally, rental income that is considered passive under IRC §469 is also considered passive for NIIT purposes. Most rental income is considered passive under the IRC §469 definitions.[132]

An activity is a rental activity if:[133]

- During the tax year, tangible property held in the activity is used by customers or held for use by customers, and
- The income from the activity is from amounts paid by customers in exchange for the use of the tangible property.

A rental activity is generally considered a passive activity without regard to whether the taxpayer materially participates in that rental activity.[134] However, there are several exceptions to this definition. These exceptions are as follows.[135]

1. The average period of customer use of the property is seven days or less.
2. The average period of customer use of the property is 30 days or less, and significant personal services are provided by or on behalf of the owner.
3. Extraordinary personal services are provided by or on behalf of the owner (without regard to any duration of customer use).
4. The rental of the property is incidental to a nonrental activity.
5. The property is customarily made available during established business hours for the nonexclusive use of customers.
6. The taxpayer provides the property for use in an activity that is conducted by a partnership, S corporation, or joint venture that is a nonrental activity in which the taxpayer owns an interest.

---

130. TD 9644, 2013-51 IRB 676, amending Treas. Reg. §§1.469-0 and -11 and enacting Treas. Reg. §§1.1411-0 through 10.
131. See Preamble, TD 9644, 2013-51 IRB 676.
132. IRC §469(c)(2).
133. Temp. Treas. Reg. §1.469-1T(e)(3)(i).
134. IRC §469(c)(2).
135. Temp. Treas. Reg. §1.469-1T(e)(3)(ii).

If any one of these exceptions exists, the taxpayer's activity will **not automatically** be considered a passive rental activity. Under these conditions, the activity is regarded as a trade or business. The taxpayer **must materially participate** in the activity for it to be categorized as active.[136] **If the taxpayer establishes material participation in that trade or business,** its income is considered active instead of passive.[137]

Example 41. Lowry owns a partnership interest in an equipment rental company. Lowry does **not materially participate** in the business. The partnership business rents out equipment to customers. They use the equipment for an average period of under seven days. The partnership business therefore is not automatically considered a passive rental activity because it qualifies for the first exception.

This means that the income from this activity is not per se passive under the passive activity loss rules or for NII purposes. However, because Lowry does **not** materially participate in the partnership activity, income from the partnership is **NII** for Lowry.[138]

Example 42. Use the same facts as **Example 41,** except that Lowry **materially participates** in the partnership activity. The rental income is generated in the ordinary course of a trade or business that is **nonpassive** to the taxpayer and is not one of the covered trades or businesses. Therefore, the partnership income received by Lowry is **not** included in his **NII.**[139]

A taxpayer may wish to group a passive rental activity with another active trade or business in order to recharacterize the passive rental income as active income. Although this is allowed, there are limitations on the taxpayer's ability to recharacterize income in this manner. Generally, a taxpayer may not group a rental activity with other trade or business activities unless they form an appropriate economic unit **and:**[140]

- Either activity is insubstantial in relation to the other, or
- The owner has the same proportionate interest in the rental as in the business.

Final NIIT regulations indicate that if the taxpayer groups a rental activity with a trade or business within these limitations and successfully recharacterizes the rental activity income as active, that rental activity income is also deemed to be derived in the ordinary course of a trade or business for NII purposes.[141] This means that the taxpayer can **exclude that income from NII** if the business is not a covered trade or business.

Note. The **proposed** form of the regulations regarding grouping and rental income indicated that a proper grouping of rental activities with other trade or business activities "will not convert gross income from rents into other gross income derived from a trade or business."[142] Prior to finalization of the regulations, the IRS took a strong position on this point. The final regulations indicate otherwise. How the IRS actually applies the grouping rules may be the determining factor on whether a taxpayer may recharacterize rental income. Although guidance in this area is limited, additional information can be found in Treas. Reg. §1.1411-5(b) related to the recharacterization of rental activity income.

Observation. Once an activity is considered a trade or business to which the NIIT does not apply, the gain on the sale of assets belonging to that activity is also excluded from NII.[143]

136. Treas. Reg. §§1.1411-5(b), 1.469-9(e)(1).
137. *Aris Valdis Jende and Marilyn Jane Jende v. Comm'r,* TC Summ. Op. 2011-82 (Jul. 6, 2011).
138. Treas. Reg. §1.1411-5(b)(3), Example 4.
139. Treas. Reg. §1.1411-5(b)(3), Example 3.
140. Treas. Reg. §1.469-4(d)(1); and Passive Activity Loss Audit Technique Guide, Chapter 8.
141. Treas. Reg. §1.1411-4(g)(6).
142. Preamble, REG-130507-11, Fed. Reg. Vol. 77, 72624.
143. IRC §1411(c)(1)(A)(iii); Treas. Reg. §1.1411-4(g)(6)(ii); and Treas. Reg. §1.1411-5(b)(3), Example 3.

Special Guidance Regarding Real Estate Rentals

To determine whether a real estate rental activity is a trade or business, a **facts and circumstances** approach must be used.[144] The varying nature of real estate rental activities precludes the development of a clear rule. Key elements that may be relevant in the analysis include the following.[145]

- Type of property (e.g., commercial real estate, residential condominium, personal property)
- Number of properties rented
- Daily involvement of the owner or owner's agent
- Type of rental arrangement (e.g., net lease, traditional lease, short- or long-term lease)

> **Observation.** This facts and circumstances approach creates significant gray areas. This is especially true given the absence of a clear definition of trade or business under the IRC §162 standard that is used for the NII rules. Further guidance or litigation in this area may be necessary in order to ascertain the IRS views and applies the relevant key elements to real estate rental situations for NII purposes.

Rent Incidental to Development[146]

Rental income incidental to development is recharacterized from passive to active if **all** the following factors apply.

- Any gain from the sale or exchange of the property is included in the taxpayer's income for the year.
- The property's use in a rental activity began less than 12 months prior to its disposition.
- The taxpayer materially or significantly participated for **any** tax year in an activity that involved performance of services to enhance the value of the property in that year. (For purposes of this rule, "significant participation" refers to the "more than 100 hours" requirement that relates to significant participation activities (SPA), discussed later.)

The **property's use** begins on the first date when all three of the following factors apply.

1. The taxpayer owns the property.
2. Substantially all of the property is either rented or held out for rent and is in a ready state for rental to tenants.
3. The construction or renovation work on the property is substantially complete.

> **Note.** For further details and guidance on these rules, see Treas. Reg. §1.469-2(f)(5).

---

144. See Preamble, TD 9644, 2013-51 IRB 676.

145. Ibid.

146. Treas. Reg. §1.469-2(f)(5).

Example 43. Clayton owns a partnership interest in Essalon Development Partners. In late 2010, the partnership acquired vacant land in a prime downtown location and arranged for the construction of a commercial plaza on the property.

Clayton materially participated in the development during 2011.

Construction work was completed, and the property was held out for rent on September 15, 2013. The partnership performed value-enhancing services to develop the property consistently from the time the property was acquired in late 2010 until construction was completed on September 15, 2013.

The partnership entered into a contract on January 1, 2013, to sell the completed property with a closing date of February 1, 2014.

The partnership's use of the building as rental property started less than 12 months before the date of disposition. Because Clayton **materially participated** in the real estate development activity in 2011, the rental income is treated as **nonpassive** in 2014, the year that the gain from the disposition is realized. As such, the rental income is not included in NII in 2014.[147]

Real Estate Professionals

Rental income from real estate may be considered nonpassive if the taxpayer is a real estate professional.[148] A taxpayer is a real estate professional if both of the following tests are met.[149]

- More than half of the personal services performed by the taxpayer during the year involve real estate trades or businesses in which the taxpayer materially participates.
- The taxpayer spends more than 750 hours per year in real property trade or business activities in which the taxpayer materially participates.

Qualifying as a real estate professional alone is not sufficient to exclude rental income from NII. In order to exclude rental income from NII, the real estate professional must also establish material participation in **the activity of renting real estate.**[150] Material participation requires **regular, substantial, and continuous** participation in the activity.

Moreover, the real estate professional must also establish that the rental activity constitutes a trade or business and that the rental income is earned in the ordinary course of that rental business. Final guidance provides a real estate professional **safe harbor test.**[151] Under this test, the real estate professional's gross rental income is deemed to be derived in the ordinary course of a trade or business if the real estate professional can establish **either** of the following.

- More than 500 hours of participation in rental real estate activities during the year, or
- More than 500 hours of participation in rental real estate activities in any five tax years within the 10 tax years that immediately precede the current tax year.

147. Treas. Reg. §1.1411-5(b)(2).

148. IRC §469(c)(7).

149. IRC §469(c)(7)(B).

150. See Preamble, TD 9644, 2013-51 IRB 676.

151. Treas. Reg. §1.1411-4(g)(7).

Accordingly, real estate professionals falling under this safe harbor may exclude their rental income from NII for the year. In addition, if this test is met, any gain or loss realized from disposition of property used in the rental activity is not included in NII.[152]

Note. If the real estate professional fails to qualify under this safe harbor, they may still be able to exclude rental income from NII under some other provision of the NIIT rules.

Note. For more information regarding real estate professionals, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. Additionally, Treas. Reg. §1.469-9 contains guidance for real estate professionals and the §469 rules for rental income.

For analyses of court cases dealing with real estate professionals, see the Rulings and Cases chapter in Volume B of both the 2013 and 2014 *University of Illinois Federal Tax Workbook.*

Self-Rental Rule

The self-rental income rule serves to recharacterize as active any income that ordinarily would be treated as passive. The self-rental income recharacterization rule applies to rental income from property that is rented for use in a trade or business activity in which the taxpayer materially participates.[153] This is a fairly common situation. An example is a physician who rents his personally owned office building to his S corporation.

Observation. This recharacterization regulation prevents the taxpayer from using a self-rental profit on Schedule E to generate additional passive income against which unused or suspended passive losses can be offset. Numerous court cases have upheld the validity of this regulation.

Self-rental income that is recharacterized as active under the self-rental rule is also deemed to be income that is derived in the ordinary course of a trade or business under the NIIT rules.[154] Accordingly, self-rental profit **is excluded from NII** and is not entered as a negative amount on line 4b on Form 8960 (2013).[155]

Note. Not all tax software includes self-rental income on Form 8960, line 4a. If the amount of self-rental income is included on line 4a, it is necessary to also include the self-rental income as a negative adjustment on line 4b (to ensure the self-rental income is not included in the overall amount of NII for the taxpayer). However, if the tax software does not include the amount on line 4a, then no negative adjustment on line 4b is necessary. In order to prevent NII from being overstated or understated for the year, it is necessary for tax return preparers to review Form 8960 closely to ensure that any adjustments shown on line 4b are necessary. For a discussion of this point and other important details regarding Form 8960, see **http://blog.aicpa.org/2014/01/interview-with-team-who-wrote-netinvestment-income-tax.html#sthash.j9h1jgDo.dpbs.**

SIGNIFICANT PARTICIPATION ACTIVITIES

A significant participation activity (SPA) is generally an activity in which the taxpayer participates for more than 100 hours during the year and in which the taxpayer ordinarily would not be considered a material participant without the SPA recharacterization rule.

Note. For further details on SPAs, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. The SPA recharacterization rule is found in Temp. Treas. Reg. §1.469-5T(a)(4), and SPAs are defined in Temp. Treas. Reg. §1.469-5T(c).

---

152. Ibid.

153. Treas. Reg. §1.469-2(f)(6).

154. Treas. Reg. §1.1411-4(g)(6).

155. 2013 Instructions for Form 8960, pp. 4 and 6.

Example 44. Marnie, who is a civil engineer, owns interests in a tavern and in a kayak store. Both the tavern and the kayak store are trade or business activities, and each has several full-time employees. During 2014, Marnie works 410 hours in the tavern business and 150 hours in the kayak store.

Both businesses are SPAs because they are not rental real estate activities. **Marnie works over 100 hours in each.** Without the special recharacterization rule for these SPAs, Marnie would be unable to establish material participation in either activity, and the income from both would be considered passive.

However, under the special SPA recharacterization rule, Marnie must aggregate her participation in both. Because her total aggregate participation of 560 hours (410 hours + 150 hours) **is in excess of 500 hours,** she is considered to materially participate in **both** activities and the income is recharacterized from passive to active.

Income that is recharacterized from passive to active under the SPA income recharacterization rule is also considered active income from a trade or business under the NII rules.[156]Accordingly, this income is not includible in the taxpayer's NII for the year.

RETIRING PARTNER PAYMENTS[157]

Regulations, still in proposed form as of the date of this publication, provide guidance on the treatment of various types of payments to a retiring partner for NIIT purposes.

The tax treatment of payments to retiring partners is determined by IRC §736, which addresses three basic types of payments to a retiring partner who is liquidating a partnership interest.

1. Payments to the retiring partner that are treated as a **distributive share** because they are made based on the partnership's continuing income after the retiring partner retires[158]
2. Payments to the retiring partner that are not determined based on the partnership's income and are therefore treated as **guaranteed payments**[159]
3. Payments to the retiring partner in **exchange for the partner's partnership interest**[160]

Any payment included in SE income is excluded from NII.[161] Guaranteed payments for services are usually included in SE income.

Under the proposed regulations, payments from partnerships are subject to NII based on the nature of the taxpayer's participation in the activity.[162] Generally, for partnership payments treated as a distributive share of income to the retiring partner, if the distribution is from a partnership in which the partner **materially participates, the amount is excluded from NII.** If the partner does not materially participate, the distribution is included in NII for the year.

Under the proposed regulations, partnership liquidation rules under IRC §469 also apply NII treatment. These rules generally state that the active or passive nature of the interest **at the time of liquidation** determines the character of the distribution payments that are made in **all subsequent years** in connection with that liquidation.[163]

---

156. Treas. Reg. §1.1411-5(b)(2).
157. Prop. Treas. Reg. §1.1411-4(g)(11).
158. IRC §736(a)(1).
159. IRC §736(a)(2).
160. IRC §736(b).
161. IRC §1411(c)(6); and Prop. Treas. Reg. §1.1411-4(g)(11)(i).
162. Prop. Treas. Reg. §1.1411-4(g)(11)(ii).
163. Prop. Treas. Reg. §1.1411-4(g)(11)(ii)(B), Example 1(ii); and Treas. Reg. §1.469-2(e)(2)(iii).

All of the income, deductions, gains, and losses attributable to the retiring partner's distributions are treated according to the partner's status as actively or not actively participating in the partnership's business prior to retirement. However, distributable income from portfolio income, interest income on working capital, and covered trades or businesses are subject to the NIIT regardless of the taxpayer's participation in the partnership's business prior to retirement.

Example 45. Benny retired in January 2014 from Benny & Partners, which is a business classified as a partnership for federal tax purposes. The partnership is not a covered business.

Under the partnership agreement, Benny is entitled to receive 15% of the net income of the partnership for 48 months after retirement. Prior to retirement, Benny materially participated in the business of the partnership. The partnership is a nonpassive activity for Benny. Benny's 2014 partnership distributions are not included as NII for the year.

Example 46. Use the same facts as **Example 45.** For 2015, the second year of the 48-month period specified in the partnership agreement, Benny's distributive share includes $100,000 of gross income from operations and $60,000 of related deductions. The **nonpassive character** of the partnership with respect to Benny at the time of liquidation in 2014 **remains fixed for the duration of his payments.** Benny's 2015 distributions are **not included** in NII.[164]

A partnership payment that is treated as a guaranteed payment may be provided in exchange for services, for use of capital, or as liquidation payments[165] for the partner's interest in the partnership.

Under the proposed regulations, guaranteed payments for **services are excluded** from NII.[166] However, guaranteed payments for **the use of capital are generally included** in NII.

Payments made for **unrealized receivables and goodwill are included in NII** as a gain from the disposition of a partnership interest.[167] Likewise, payments made to buy out the partner's interest are treated as proceeds from the sale of the partner's investment. [168] As such, the net gain or loss is generally taken into account for NII purposes.[169]

Note. The proposed regulations also provide guidance for installment sales when certain types of partnership payments are received in more than one tax year. See Prop. Treas. Reg. §1.1411-4(g)(11)(v).

164. Treas. Reg. §1.469-2(e)(2)(iii).
165. IRC §736(a)(2).
166. Prop. Treas. Reg. §1.1411-4(g)(10).
167. Prop. Treas. Reg. §1.1411-4(g)(11)(iii)(A).
168. IRC §731(a).
169. Prop. Treas. Reg. §1.1411-4(g)(11)(iv).

BUSINESSES AND ACTIVITIES INVOLVING INVESTMENT TRADING

Income from a trade or business engaged in trading financial instruments or commodities is a **covered business** subject to the NIIT rules.[170] **For tax purposes, a taxpayer who purchases and sells securities is categorized as an investor, dealer, or trader.**

An **investor** is a taxpayer who buys or sells securities for the principal purpose of obtaining investment income and gains by retaining the investments over a relatively long period of time.[171] An investor's profits **are subject to NIIT** because the assets are not being held in the course of a trade or business. Investment fees, advisory fees, and other investment expenses are deductible for income tax purposes and for NIIT purposes. These expenses, after the 2%-of-AGI limitation has been applied, are entered on line 9c of Form 8960 (2013).

A **dealer** is generally a taxpayer who regularly buys securities for (or sells securities to) customers or offers to engage in various securities transactions with customers.[172] The net income of a taxpayer from the business of being a dealer is by definition subject to NIIT.[173]

The definition of **trader** is not provided anywhere in the Code or regulations but has been developed through case law. The definition of trader can be summarized as someone who engages in the following activities.

- Trades a large volume of transactions on a regular basis but has no customers[174]
- Purchases and sells securities frequently to take advantage of daily market movements for short-term profits[175]
- Obtains profits through direct management of buying and selling[176]
- Focuses on short-term trading instead of holding investments long-term, and derives income principally from the sale of securities instead of from the receipt of dividends or interest from the securities[177]

The net income of a business in which the primary activity is trading securities or commodities is by definition subject to NIIT.[178] A person in the business of trading securities or commodities reports the activity of the business in a manner that is different from most businesses.[179] If the trader **has not made a mark-to-market election** under IRC §475(f), the proceeds from the trading activities are reported on Schedule D, *Capital Gains & Losses*, and Form 8949, *Sales and Other Dispositions of Capital Assets*, as appropriate. If the trader **has** made a mark-to-market election, the proceeds are reported on Form 4797, *Sales of Business Property*. Regardless of the mark-to-market election, the expenses of the business are reported on Schedule C.

The net profit or loss from trading is reported on line 5a of Form 8960 (2013). If the taxpayer does not have any income subject to SE tax, all the expenses of the trading business may be subtracted from NII on line 10 of Form 8960 (2013).[180] If the taxpayer has income subject to SE tax, the regulations limit the amount of the trading expenses that may be deducted from NII to the amount of expenses that exceed SE income.[181] A special worksheet (shown following) is provided in the instructions to Form 8960 to calculate this amount.

---

170. IRC §1411(c)(2)(B).
171. Preamble, REG 130507-11, Fed. Reg., Vol. 77, 72625.
172. *Marlowe King v. Comm'r*, 89 TC No. 445 (Sep. 9, 1987).
173. IRC §1411(c)(2)(B).
174. *Marlowe King v. Comm'r*, 89 TC No. 445 (Sep. 9, 1987).
175. *C. H. Laing v. Comm'r*, 23 TC No. 1040 (Mar. 18, 1955).
176. *R. E. Purvis v. Comm'r,* TC Memo 1974-164 (Jun. 24, 1974); *aff'd per curiam* 530 F.2d 1332 (9th Cir. 1976).
177. Ibid.
178. IRC §§1411(c)(2)(B) and (6).
179. *Topic 429 — Traders in Securities (Information for Form 1040 Filers).* Feb. 27, 2014. [www.irs.gov/taxtopics/tc429.html] Accessed on Jul. 1, 2014.
180. Instructions for 2013 Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts*.
181. Treas. Reg. §1.1411-9(b).

Line 10—Worksheet for Traders in Financial Instruments That Maintain More Than One Trade or Business

Keep for Your Records

Use this worksheet to determine the amount on line 10.

1	Enter the total amount from Schedule SE (Form 1040), line 3.	1	
2	a If the amount on Schedule SE (Form 1040), line 3, is zero or greater, you cannot use the expenses from your trade or business to reduce your investment income. Stop here.		
	b If the amount on Schedule SE (Form 1040), line 3, is a negative amount, enter your expenses from your trade or business of trading in financial instruments or commodities (entered as a positive amount).	2 b	
3	Add line 1 to line 2b.	3	
	a If the amount on line 3 of this worksheet is zero or less, include the trade or business expenses (line 2b of the worksheet) on Form 8960, line 10.		
	b If the amount on line 3 of this worksheet is a positive number, convert the amount from Schedule SE (Form 1040), line 3 (line 1 of this worksheet) into a positive number and include it on Form 8960, line 10.		

The net profit from the trading activities of a taxpayer who is not in the business of trading is also subject to NIIT, because the gain is from the disposition of assets not held in a trade or business.[182] The related expenses are deductible for income tax purposes as miscellaneous itemized deductions on Schedule A, subject to the 2%-of-AGI limitation. These expenses are also allowed as deductions in Part II of Form 8960 after the 2% limitation is applied.

Example 47. Edgar is self-employed and engages in the trade or business of trading commodities. Edgar made an election under IRC §475(f) for 2014 to use the mark-to-market method of accounting.

For 2014, Edgar has $600,000 in trading gains and $25,000 in expenses from operating the trading business. Because Edgar is a **trader,** none of the gross income or deductions are taken into account for SE purposes. The $600,000 of trading gains is net income from a covered trade or business and is included in his 2014 NII. The $25,000 of expenses is deductible[183] from his 2014 NII on Form 8960.

Note. For detailed information regarding investors, dealers, and traders, see the 2014 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 4: Special Taxpayers.

NIIT AND ADDITIONAL MEDICARE TAX

Income subject to the Medicare tax under the SE tax rules[184] is not income that is includible in the taxpayer's NII and is **not** subject to the NIIT.[185] SE income and the related deductions are **not** taken into account for NII purposes **unless** the activity involves trading in financial instruments or commodities. However, any item **specifically excluded from net SE income** may be included in NII if it falls under the NIIT rules.

The additional Medicare tax (discussed next) applies to income earned from self employment. For high-income taxpayers, the interaction of the NIIT and the additional Medicare tax means that certain tax strategies to save Medicare taxes are no longer effective.

182. IRC §1411(c)(1)(A)(iii).

183. As properly allocable expenses under IRC §62.

184. See IRC §1401(b).

185. Treas. Reg. §1.1411-9.

ADDITIONAL MEDICARE TAX

The following acronyms are used in this section.

- ACA — Affordable Care Act
- AGI — Adjusted gross income
- ATRA — American Taxpayer Relief Act
- FICA — Federal Insurance Contributions Act
- HoH — Head of household
- MAGI — Modified adjustable gross income
- MFJ — Married filing jointly
- MFS — Married filing separately
- NII — Net investment income
- NIIT — Net investment income tax
- QW — Qualifying widow or widower
- RRTA — Railroad Retirement Tax Act
- SE — Self employment

ACA added §3101(b)(2) to the Code. This new Code section requires the payment of a 0.9% tax, called the additional Medicare tax. This is an entirely separate tax from the 3.8% NIIT discussed in the previous section. Treasury Regulations covering the additional Medicare tax were finalized on November 29, 2013. TD 9645 contains the IRS's explanations and a complete list of the amendments made to the regulations affected by this tax.

TAXPAYERS AFFECTED

Taxpayers with wages and/or SE income **above a certain threshold** are subject to the additional Medicare tax. These **threshold amounts** are as follows.

> **Note.** These threshold amounts are the same as the **MAGI** threshold amounts for application of the 3.8% NIIT discussed in the previous section. However, the thresholds for the additional Medicare tax apply **only to wages and SE income** and not MAGI.

Filing Status	Threshold Amount
MFJ	$250,000
MFS	125,000
Single, HoH, QW	200,000

Taxpayers with wages and SE income amounts **below** these thresholds are **not** subject to the 0.9% additional Medicare tax for 2013 and subsequent tax years. These thresholds are **not** adjusted for inflation.

Corporations, estates, and trusts are **not** subject to the additional Medicare tax.[186]

[186.] IRC §3101(b)(2).

TYPES OF INCOME AFFECTED

In general, any type of income subject to Medicare taxes is also subject to the additional Medicare tax if the taxpayer's total applicable income exceeds the threshold amount for the taxpayer's filing status. The two primary types of such income are:

- Wages and other compensation from employment, and
- SE income.[187]

Note. For additional details on the specific types of income that do and do not fall into the above categories, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

Wages and Other Compensation

For 2014, the following rates apply to wages under the Federal Insurance Contributions Act (FICA).

Note. Although the **social security portion of FICA** applies only to the first **$117,000** of wages for 2014, there is no upper limit on the wage amount to which the Medicare tax applies.

	Employer Portion	Employee Portion	Total
Social security	6.2%	6.2%	12.4%
Medicare	1.45%	1.45%	2.9%
Total	7.65%	7.65%	15.3%

Effective for 2013 and subsequent tax years, wages and other compensation in excess of threshold amounts are subject to withholding for the 0.9% additional Medicare tax.[188]

Self-Employment Income

Taxpayers who are self employed must pay the additional Medicare tax on their net SE income as calculated on their Schedule SE, *Self-Employment Tax*. However, the additional Medicare tax is not part of the SE tax that qualifies as a deduction against AGI on page 1 of Form 1040.

EMPLOYER WITHHOLDING AND THE ADDITIONAL MEDICARE TAX

Any tax liability for the additional Medicare tax is paid by the taxpayer. There is no corresponding amount owed by an employer and no "employer portion" to be matched by a taxpayer with SE income.[189]

An employer must withhold an additional 0.9% of all wages that exceed $200,000 paid to an employee.[190] This $200,000 threshold must be used by the employer **regardless** of what the employee's actual applicable threshold is based on their filing status under the additional Medicare tax rules.[191] The employer is also not responsible for taking into account any wages paid to the employee's spouse or any wages paid to the employee by another unrelated employer for whom the employee works.[192]

187. IRC §§3101(b)(2) and 1401(b)(2).

188. IRC §3102(f)(1).

189. Preamble, REG-130074-11, 2012-52 IRB 790.

190. IRC §3102(f)(1); and Treas. Reg. §31.3102-4(a).

191. Treas. Reg. §31.3102-4(a).

192. Ibid.

It may be possible for the taxpayer to owe additional Medicare tax when there was no employer withholding. This occurs when the taxpayer's total wages subject to the additional Medicare tax exceed the applicable threshold even though the income from each employer is **less** than the $200,000 withholding threshold.

An employer may not withhold additional Medicare tax on wages of less than $200,000. However, an employee may request that an employer withhold additional income taxes, which can be applied to any potential balance due with the taxpayer's income tax return.[193] This is accomplished by completing a revised Form W-4, *Employee's Withholding Allowance Certificate.*

Note. Requesting additional tax withholding may be prudent for a taxpayer who has substantial additional Medicare tax or NIIT liability, because both of these taxes may trigger estimated tax penalties.

Employer Liability and Method Used for Withholding

If the employer does not withhold a sufficient amount of additional Medicare tax from an employee, the employee is still liable for the tax.[194] However, if the employer withholds less than the correct amount of tax, the employer is liable for the tax unless and until the employee pays it.[195] However, even after the employee pays the tax, the employer remains liable for any penalties for failure to withhold as required.[196]

The final regulations state that an employer is not relieved of its liability for payment of any additional Medicare tax required to be withheld **unless** it can show that the tax was paid by the employee.[197] Employers must use Form 4669, *Statement of Payments Received*, and Form 4670, *Request for Relief from Payment of Income Tax Withholding*, to request relief from paying additional Medicare tax that was already paid by the employee.

Employer Correction Procedures

If an employer **underwithholds** the additional Medicare tax from an employee's compensation and discovers that error in the same calendar year in which that compensation was paid, the employer may correct the error by making an interest-free adjustment using the appropriate return (such as a Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*). Once the error is discovered, the required amount of additional Medicare tax should be deducted from other compensation paid to the employee before the end of the calendar year.[198]

If the employer is unable to withhold the correct amount from an employee's compensation, the employer still must report and pay the required amount on its return. When the employer pays this amount on behalf of the employee in this manner, the employer must request reimbursement from the employee.[199]

An employer that **overwithholds** the additional Medicare tax and discovers the error before the end of the calendar year should reimburse the employee for the excess amount withheld.[200] If the employee is reimbursed, the employer may use the interest-free adjustment method to apply for a refund of the tax overpaid to the IRS.[201] The claim for refund should be filed using the appropriate amended return.

193. Preamble, REG-130074-11, 2012-52 IRB 790.
194. Treas. Reg. §31.3102-4(b).
195. Treas. Reg. §31.3202-1(g)(3).
196. Ibid.
197. Treas. Reg. $31.3102-4(c).
198. Treas. Reg. §31.6205-1(b)(4).
199. Treas. Reg. §31.6205-1(d)(1).
200. Treas. Reg. §31.6413(a)-1(a)(2).
201. Treas. Reg. §31.6413(a)-2(b).

If the employer does not reimburse the employee for the excess withholding, the interest-free adjustment method cannot be used. Furthermore, the employer must report the excess amount of additional Medicare tax on the employee's Form W-2. The employee can claim the excess withholding as a credit on their individual income tax return.

> **Note.** The employer may reimburse the employee by using the overwithheld additional Medicare tax to reduce the employee's subsequent FICA withholding within the same calendar year.[202]

Discovery in a Subsequent Year.[203] An employer that **underwithholds** the additional Medicare tax and does not discover the error until after the end of the year in which the compensation was paid cannot correct the error using the interest-free adjustment method. However, if the employer is able to establish that the employee paid the additional Medicare tax, the IRS does not seek to collect that amount from the employer, but the employer is still liable for any penalties.

An employer that **overwithholds** the additional Medicare tax and does not discover the error until a subsequent year cannot correct the error using the interest-free adjustment method. The employer must report the amount of excess additional Medicare tax on the employee's Form W-2. This enables the employee to obtain a credit for the excess additional Medicare tax withheld.

> **Note.** Additional guidance on employer withholding correction procedures with respect to the additional Medicare tax can be found in Treas. Reg. §§31.3102-1, 31.3102-4, and 31.3202-1. Guidance is also available at **www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax.**

TAXPAYERS WITH MEDICARE WAGES, RRTA WAGES, OR SE INCOME

A special coordination rule exists for taxpayers who have both wage income and SE income. The taxpayer's applicable threshold is reduced (but not below zero) first by their wage amount. The reduced threshold is then applied to the taxpayer's SE income to determine whether there is any additional Medicare tax liability.[204] The additional Medicare tax is calculated and reported on Form 8959, *Additional Medicare Tax.*

Example 48. In 2014, Henry is a single filer who has SE income of $145,000 and wage income of $130,000. Because Henry's wages are not in excess of $200,000, his employer does not withhold any additional Medicare tax.

The amount of Harry's income that is subject to the additional Medicare tax is calculated as follows.

SE income		$145,000
Threshold	$200,000	
Less: wages	(130,000)	
Amount remaining	$ 70,000	(70,000)
SE income subject to the additional Medicare tax		$ 75,000

202. Treas. Reg. §31.6413(a)-1(a)(2)(iv).

203. Questions 56 and 57 from *Questions and Answers for the Additional Medicare Tax*. Jun. 24, 2014. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax] Accessed on Jul. 2, 2014.

204. Treas. Reg. §1.1401-1(d)(2).

For Example 48

Form **8959**

Department of the Treasury
Internal Revenue Service

Additional Medicare Tax

► If any line does not apply to you, leave it blank. See separate instructions.
► Attach to Form 1040, 1040NR, 1040-PR, or 1040-SS.
► Information about Form 8959 and its instructions is at *www.irs.gov/form8959.*

OMB No. 1545-0074
2013
Attachment Sequence No. 71

Name(s) shown on Form 1040	Your social security number
Henry	987-65-4321

Part I Additional Medicare Tax on Medicare Wages

1	Medicare wages and tips from Form W-2, box 5. If you have more than one Form W-2, enter the total of the amounts from box 5	1	130,000		
2	Unreported tips from Form 4137, line 6	2			
3	Wages from Form 8919, line 6	3			
4	Add lines 1 through 3	4	130,000		
5	Enter the following amount for your filing status: Married filing jointly . . . $250,000; Married filing separately . . . $125,000; Single, Head of household, or Qualifying widow(er) $200,000	5	200,000		
6	Subtract line 5 from line 4. If the result is zero or less, enter -0-			6	0
7	Additional Medicare Tax on Medicare wages. Multiply line 6 by 0.9% (.009). Enter here and go to Part II			7	0

Part II Additional Medicare Tax on Self-Employment Income

8	Self-employment income from Schedule SE (Form 1040), Section A, line 4, or Section B, line 6. If you had a loss, enter -0- (Form 1040-PR and Form 1040-SS filers, see instructions.)	8	145,000		
9	Enter the following amount for your filing status: Married filing jointly . . . $250,000; Married filing separately . . . $125,000; Single, Head of household, or Qualifying widow(er) $200,000	9	200,000		
10	Enter the amount from line 4	10	130,000		
11	Subtract line 10 from line 9. If zero or less, enter -0-	11	70,000		
12	Subtract line 11 from line 8. If the result is zero or less, enter -0-			12	75,000
13	Additional Medicare Tax on self-employment income. Multiply line 12 by 0.9% (.009). Enter here and go to Part III			13	675

Part III Additional Medicare Tax on Railroad Retirement Tax Act (RRTA) Compensation

14	Railroad retirement (RRTA) compensation and tips from Form(s) W-2, box 14 (see instructions)	14			
15	Enter the following amount for your filing status: Married filing jointly . . . $250,000; Married filing separately . . . $125,000; Single, Head of household, or Qualifying widow(er) $200,000	15			
16	Subtract line 15 from line 14. If zero or less, enter -0-			16	
17	Additional Medicare Tax on railroad retirement (RRTA) compensation. Multiply line 16 by 0.9% (.009). Enter here and go to Part IV			17	

Part IV Total Additional Medicare Tax

18	Add lines 7, 13, and 17. Also include this amount on Form 1040, line 60, (Form 1040NR, 1040-PR, and 1040-SS filers, see instructions) and go to Part V	18	675

Part V Withholding Reconciliation

19	Medicare tax withheld from Form W-2, box 6. If you have more than one Form W-2, enter the total of the amounts from box 6	19	1,885		
20	Enter the amount from line 1	20	130,000		
21	Multiply line 20 by 1.45% (.0145). This is your regular Medicare tax withholding on Medicare wages	21	1,885		
22	Subtract line 21 from line 19. This is your Additional Medicare Tax withholding on Medicare wages			22	0
23	Additional Medicare Tax withholding on railroad retirement (RRTA) compensation from Form W-2, box 14 (see instructions)			23	
24	**Total Additional Medicare Tax withholding.** Add lines 22 and 23. Also include this amount with federal income tax withholding on Form 1040, line 62 (Form 1040NR, 1040-PR, and 1040-SS filers, see instructions)			24	0

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59475X Form **8959** (2013)

Under the applicable Code sections, the additional Medicare tax is actually three separate taxes assessed on:

1. Wages subject to Medicare taxes, [205]
2. SE income,[206] and
3. Wages subject to the Railroad Retirement Tax Act (RRTA).[207]

The applicable thresholds are the same for all three taxes. However, as shown in the previous example, the threshold for SE income is reduced by the amount of Medicare wages.[208] In contrast, the threshold for RRTA wages is not adjusted by the other two types of income.[209]

Example 49. Stephanie is a railroad employee. In 2014, she has $160,000 of wages subject to RRTA. She also receives $180,000 of wages from the local university, which is subject to Medicare tax. Stephanie's $160,000 of RRTA income is not subject to the additional Medicare tax because it is below her $200,000 threshold. Moreover, her $180,000 of wage income from the university is not subject to the additional Medicare tax because it is also below her $200,000 threshold. Stephanie has no additional Medicare tax liability for 2014.

Because the assessment of the additional Medicare tax is based on income received, **neither Medicare wages nor RRTA wages are reduced by any SE-related losses for purposes of this tax.**

Example 50. In 2014, Jenny, a single taxpayer, has $235,000 of wage income as a bank executive. During 2014, her consulting business, operated as a sole proprietorship, incurred a **loss** of $60,000. Because an SE loss is not netted against wages under the additional Medicare tax rules, Jenny cannot reduce her wage income that is subject to the additional Medicare tax by her loss from self employment.

Jenny's employer must withhold the 0.9% additional Medicare tax on $35,000, the amount of her wages in excess of $200,000. If she has no additional wages or SE income from any other sources, the amount withheld from her wages as a bank executive will equal the amount of additional Medicare tax she owes for 2014.

---

205. IRC §§3101(b)(2) on wages defined in IRC §3121(a).

206. IRC §1401(b)(2).

207. Railroad employees: IRC §3201(a). Railroad employee representatives: IRC §3211(a).

208. IRC §1401(b)(2)(B).

209. Treas. Reg. §1.1401-1(d)(2). See also Form 8959 and the related instructions.