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Taxpayers that paid the net investment income tax or the additional Medicare tax should consider filing protective claims for refund

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Individuals, estates, and trusts that paid significant amounts of the 3.8% net investment income tax or the 0.9% additional Medicare tax in 2016 or later years should consider filing protective claims for refund of those taxes that may become available subject to the outcome of litigation pending before the Supreme Court of the United States.

By way of background, the Patient Protection and Affordable Care Act (the "ACA") requires most individuals to maintain a minimum level of health insurance coverage, known as the "individual mandate."

People who do not maintain this coverage must pay the federal government a financial penalty, known as the "shared responsibility payment."

In *National Federation of Independent Business v. Sebelius*, the Supreme Court upheld the constitutionality of the individual mandate as an exercise of Congress' taxing power.

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In the Tax Cuts and Jobs Act of 2017 (the "TCJA"), Congress effectively eliminated the individual mandate for months beginning after December 31, 2018, by setting the amount of the shared responsibility payment at zero dollars (*i.e.*, even if an individual did not comply with the individual mandate, the penalty for noncompliance is zero).

Following the enactment of the TCJA, 20 Republican state attorneys general and governors and two individuals filed a lawsuit challenging the ACA, arguing that the individual mandate is no longer constitutional because, as a result of the TCJA, the shared responsibility payment would no longer produce at least some revenue for the federal government (thereby making it more difficult — if not impossible — to claim that the individual mandate was constitutional under Congress' taxing power).

The trial court struck down the individual mandate as unconstitutional and the United States Court of Appeals for the Fifth Circuit affirmed that decision on appeal. The Supreme Court has agreed to hear the case, *California v. Texas*, and oral argument should occur later this year.

President Trump, for his part, has called for the Supreme Court to strike down the individual mandate and the entire ACA. A ruling from the Supreme Court that the ACA is unconstitutional will have far-reaching implications, potentially including with respect to taxation.

The ACA contains several tax-related provisions, including the 3.8% net investment income tax and the 0.9% additional Medicare tax on earned income.

The net investment income tax is an additional 3.8% tax on "net investment income," which generally includes:

- Capital gain, interest, dividends, certain annuities, royalties, and certain rents (unless derived from a business activity in which the taxpayer materially participates);
- Income and gains from a business activity in which the taxpayer does not materially participate; and
- Income and gains from the trading of financial instruments and commodities (whether or not the taxpayer materially participates), in each case subject to exceptions and qualifications set forth in the Treasury Regulations.

The net investment income tax applies to:

(1) Estates and trusts that have undistributed net investment income and adjusted gross income above $12,400 for 2016 (and a similar inflation-adjusted amount for later years); and

(2) Individuals electing the married filing jointly filing status with adjusted gross income above $250,000 ($200,000 using the single filing status).

The additional Medicare tax is an additional 0.9% on wages, salaries, and self-employment income in excess of $250,000 for

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individuals who elect the married filing jointly filing status ($200,000 using the single filing status).

If the ACA is struck down as unconstitutional, then the net investment income tax and the additional Medicare tax were impermissibly levied.

Consequently, a taxpayer who paid either or both of those taxes may potentially be entitled to a refund of the tax paid, provided that an administrative claim for refund is timely filed with the IRS.

A taxpayer's ability to claim a refund for 2016 or any subsequent year will depend upon the scope of the Supreme Court's ruling in *California v. Texas*.

This tax-centric alert does not consider all of the constitutional issues that may need to be considered, but we can envision circumstances in which the Supreme Court's ruling could affect the ability of a taxpayer to claim a refund of the net investment income tax or the additional Medicare tax.

For example, under well-settled constitutional law principles, any law contrary to the Constitution is void, which means the law never had any legal effect.

A ruling from the Supreme Court that the ACA is unconstitutional and (under existing precedent) void would certainly support a taxpayer's refund claim for ACA-related taxes paid in 2016 and all later tax years for which any ACA tax was levied.

However, a ruling from the Supreme Court that the ACA was constitutional prior to the enactment of the TCJA might eliminate a taxpayer's ability to claim a refund of the net investment income tax or the additional Medicare tax for the 2016 through 2018 tax years (prior to the effective date of the repeal of the individual mandate on January 1, 2019), but not for 2019 and subsequent tax years (after the effective date of the repeal).

As noted, the resolution of these issues cannot be known until after the Supreme Court releases its opinion in *California v. Texas*.

But regardless of the constitutional law issues, any taxpayer who desires to potentially recoup all or a portion of the net investment income tax or the additional Medicare tax on earned income for any tax year must take steps to protect his or her legal rights to claim the refund or refunds.

Taxpayers have a limited time within which to claim a refund of an overpayment of any tax, including the net investment income tax and the additional Medicare tax.

Specifically, a claim for refund of any overpayment of tax is generally required to be filed within the later of (1) three years from the time the return was filed or (2) two years from the time the tax was paid.

The Internal Revenue Code prohibits the IRS from issuing a refund of tax after the statute of limitations expires unless the taxpayer files an administrative claim for refund before the statute of limitations expires.

Thus, calendar-year taxpayers who timely filed their 2016 income tax return *without extension* normally would have had to file a claim for refund with respect to taxes paid for the 2016 tax year by April 15, 2020 (i.e., three years from the date on which a timely or early-filed tax return for 2016 is deemed filed).

However, as a result of COVID-19-related relief from the IRS that extended many time-sensitive acts, including the time within which to file a claim for refund otherwise required to be filed between April 1 and July 15, 2020, taxpayers who filed a 2016 income tax return without extension and who desire to claim a refund of taxes paid for the 2016 tax year must act no later than July 15, 2020.

Calendar-year taxpayers who filed their 2016 tax return *on extension* would usually have until three years from the date the 2016 tax return was filed to file a claim for refund.

Therefore, taxpayers who filed a 2016 income tax return on extension and who desire to claim a refund of taxes paid for the 2016 tax year may have until as late as October 17, 2020, to file a claim for refund.

Taxpayers who desire to file a refund claim for any tax year after 2016 have additional time to act, though it may be most cost-effective to prepare and file multiple years' claims for refund at the same time.

And even though the Supreme Court decision that might entitle a taxpayer to the refunds described above has not been rendered, a taxpayer may nevertheless protectively file an administrative claim for refund.

A taxpayer may file a protective claim for refund to preserve its right to claim a refund when the right to the refund is contingent on future events and may not be determinable until after the statute of limitations to file a claim for refund expires.

Protective claims may be informal claims, formal claims, or amended tax returns for a refund that are normally based on expected changes in current litigation, pending legislation, or a current regulation. A protective claim for refund need not demand an immediate refund or list a particular amount to be refunded.

However, for a protective claim for refund to be valid, it must:

(1) Be received by the IRS or postmarked by the United States Postal Service or an approved private delivery service before the expiration of the period of limitations for filing a claim for refund;

(2) Be in writing and signed;

(3) Include the taxpayer's name, address, taxpayer identification number, and other contact information;

(4) Identify and describe the contingencies affecting the claim;

(5) Be sufficiently clear to alert the IRS to the essential nature of the claim; and

(6) Identify the specific year or years for which a refund is claimed.

Taxpayers should file a separate claim for each taxable period and keep proof of mailing of each claim, including the date on which the claim was mailed.

Finally, a best practice where the contingency relevant to a protective claim is based on the outcome of current litigation is for the protective claim to identify the relevant court case by name, though the failure to do so does not affect the validity of a protective claim.

Typically, the IRS will delay acting on the protective refund claim until the contingency affecting the determinability of the claim is resolved.

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If the IRS disallows a protective claim for refund at the time of filing, the taxpayer should request additional time to supplement the claim with the legal theories and factual bases supporting the taxpayer's right to the refund.

And in the absence of express approval from the IRS to file a supplement to the claim, the taxpayer should nevertheless supplement the protective claim as soon as possible.

Once the contingency is removed, the taxpayer should promptly perfect the protective claim. Perfection is accomplished by filing a complete refund claim with an enclosure letter explaining the circumstances of the filing and providing a copy of the protective claim and proof that the protective claim was timely filed.

In perfecting the claim, the taxpayer should be sure to specify all factual and legal bases the taxpayer may rely upon in litigation to support the refund.

Taxpayers are generally barred from presenting claims in a refund suit that substantially vary from the legal theories and factual bases set forth in the administrative refund claim presented to the IRS.

Individuals, estates, and trusts that paid the net investment income tax or the additional Medicare tax should consider filing protective claims for refund with respect to those taxes so as to preserve their right to a refund if the Supreme Court declares the ACA unconstitutional.

A cost-benefit analysis should be performed, most likely in consultation with a tax return preparer, to determine whether the potential benefit of a refund of those taxes outweighs the cost of preparing and filing a refund claim.

And given the hypertechnical rules relating to the filing and perfection of protective claims for refund, it may be advisable to consult tax counsel for additional guidance.

For many taxpayers, the tax "savings" will not be worth the cost (or the administrative burden) of amending prior years' tax returns.

But for taxpayers who earned significant investment income or who are higher-income earners, a refund of the net investment income tax or the additional Medicare tax may be substantial.

The taxpayers most likely to benefit from filing one or more protective claims for refund are estates, individuals, and trusts that:

- Engaged in capital transactions, like the sale of a business;
- Recognized gains from the disposition of property (to the extent the gain is taken into account in computing taxable income) other than property held in a trade or business to which the net investment income tax does not apply;
- Sold capital assets and recognized relatively significant capital gain;
- Earned relatively significant income from interest, dividends, certain annuities, royalties, and rents (unless derived in a trade or business to which the net investment income tax does not apply); or
- Are highly compensated and paid the 0.9% additional Medicare tax.

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