I find it difficult to explain to clients that, while they paid more in federal taxes on their income in 2013, they did not technically get hit with an income tax increase: The top marginal income tax rate for the wealthy has reverted to its previous level because the Bush tax cuts expired at the end of 2012, and the new 3.8 percent net investment income tax (NIIT) is not technically a tax on income but a Medicare tax on investment.

Still, the net effect is to increase the effective tax rate for wealthy individuals and families on investment income, other than qualified dividends and long-term capital gains, to 43.4 percent—a 24 percent increase from 35 percent—and on qualified dividends and long-term capital gains to 23.8 percent, up from 15 percent, an astonishing 59 percent increase. The NIIT typically applies to married couples filing jointly with adjusted gross income of at least $250,000 and single people with adjusted gross income of at least $200,000.

The NIIT was enacted to fund the Patient Protection and Affordable Care Act, aka Obamacare. It generally applies to income such as interest, dividends, rents, royalties, annuities and gains from the sale of property, to the extent these categories of investment income are not derived in the ordinary course of a trade or business, and to income from trades or businesses in which the taxpayer does not “materially participate.” The NIIT and the traditional Medicare tax on salary, commissions and other forms of so-called earned income cannot apply to the same income, so only one 3.8 percent levy may be imposed.

What many taxpayers may not realize is that, in some instances, neither tax will apply.

Consider the example of a partner—let’s call him Joe—who works full-time in a business conducted
through a simple flow-through general partnership. Joe is allocated $1 million of income, paid in partnership distributions. The IRS would treat Joe’s $1 million as self-employment income subject to both the regular income tax and the 3.8 percent Medicare tax.

If the business was instead conducted through a closely held C corporation in which Joe was a shareholder, the C corporation would of course be subject to the regular corporate income tax. But Joe would also have to pay a second income tax of 20 percent on any dividends he receives from the C corporation, as well as a 3.8 percent tax on the dividends because of the NIIT—a collective tax of over 50 percent.

Because the payment of dividends from a C corporation is so tax inefficient, Joe and the C corporation might pay all or some of the C corporation’s taxable income to Joe as salary rather than dividends. This payment would, unlike dividends, be deductible to the C corporation, but would subject Joe to income tax on the salary he receives as well as the 3.8 percent Medicare tax. If the entire $1 million were paid to Joe as compensation, Joe would effectively be in the same federal income tax position he would have been in if he were a partner. All his income would be subject to both the regular income tax and the 3.8 percent Medicare tax.

Now consider what would happen if the C corporation were instead an S corporation. The payments to Joe could legally be divided between reasonable compensation paid him as a salary subject to the Medicare tax, and S corporation “dividends” exempt from the Medicare tax. If the facts justified reasonable compensation for Joe’s services of, say, only $250,000, then the remaining $750,000, a “dividend,” would be exempt from all self-employment taxes. And, since Joe “materially participates” in the business, the remaining $750,000 would also be exempt from the NIIT. So using an S corporation would permit Joe to avoid both the 3.8 percent Medicare tax and the NIIT on $750,000.

While many taxpayers have had sticker shock from the NIIT, with proper planning, some of its adverse effects can be mitigated.