3.8% NET INVESTMENT INCOME TAX (NIIT) — 2013

Under current law, HI (Medicare) tax is assessed only on earned income.

Beginning in 2013, the law imposes a net investment income tax (NIIT) on individuals, estates, and trusts. (IRC §1411) To the extent that the amount of income exceeds the threshold, the taxpayer must pay 3.8% additional HI tax on net investment income. The tax does not apply to nonresident aliens, a trust devoted exclusively to charitable purposes, a trust exempt from tax under IRC §501, or a charitable remainder trust exempt from tax under IRC §664. (IRC §1411(e)(1))

The threshold amounts are the same as the threshold amounts for earned income:

- $250,000 for joint returns;
- $125,000 for married filing separate; and
- $200,000 for all others.

The threshold amounts are not indexed for inflation, so an increasing number of taxpayers may be affected in each succeeding year.

For estates and trusts, the tax is 3.8% of the lesser of:

- Undistributed net investment income; or
- The excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins.

Note: For 2012, the highest estate and trust income tax bracket begins at $11,650. This amount is indexed for inflation.

For individuals, the tax is 3.8% of the lesser of:

- Net investment income; or
- The excess of modified adjusted gross income (MAGI) over the threshold amount.

MAGI is adjusted gross income increased by any amount excluded under IRC §911 as foreign earned income net of the deductions and exclusions disallowed with respect to the foreign earned income.

Example of additional HI tax

In 2013, Maggie has $90,000 of interest income and no other income. She is not subject to the NIIT because she is under the $200,000 MAGI threshold.

In 2014, she gets a job and earns $140,000, and still earns $90,000 of interest income. She will pay additional HI tax on investment income of:

MAGI	$230,000
Threshold	200,000
Excess	30,000
Investment income	90,000
Lesser of excess or investment income	30,000
Tax rate	3.8%
Additional HI tax	$ 1,140

Nonresident aliens

The NIIT applies to U.S. citizens and residents. It does not apply to nonresident aliens.

A U.S. person married to a nonresident alien generally files married filing separate. Accordingly, they determine their own MAGI and net investment income, and they are subject to a $125,000 threshold.

However, if they file an election under IRC §6013(g) to file a joint return, they are treated as filing joint for NIIT purposes. They must combine their MAGI and their net investment income and they can use the full $250,000 threshold.

U.S. territories

The treatment of *bona fide* residents of U.S. territories varies depending on whether the individuals are residents of Guam, the Northern Mariana Islands, or the U.S. Virgin Islands, who are not subject to the tax, or Puerto Rico or American Samoa, who may be subject to the tax. (Prop Treas. Regs. Sec. 1.1411-2(a)(2)(iv))

Short taxable year

If a taxpayer dies during the year, the threshold amount is not prorated. (Prop. Treas. Regs. §1.1411-2(d)(2)(i)) For example, the threshold amount remains at $200,000 for Year 1 even if a single taxpayer dies in January, Year 1.

However, a taxpayer who changes his or her annual accounting period must prorate the threshold amount based on the number of months in the short year.

Includes parent's election

The amounts of net investment income included on a parent's return because of the parent's election under IRC §1(g)(7) to report children's income on the parent's own return (Form 8814, Parents' Election to Report Child's Interest and Dividends) is included in the parent's income for NIIT purposes. (IRS Net Investment Income Tax FAQs, www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs) However, the calculation of net investment income does not include the amounts excluded due to the threshold amounts on Form 8814.

Net investment income

Net investment income is investment income reduced by deductions properly allocable to such income. Investment income includes:

- Gross income from dividends, interest, annuities, royalties, and rents, less allocable deductions unless these items are derived in the ordinary course of a trade or business to which the HI tax does not apply;
- Other gross income derived from a trade or business to which the HI tax applies; and
- Net taxable gain attributable to the disposition of property other than property held in a trade or business to which the HI tax does not apply. (IRC §1411(c)(1))

Trade or business income

Generally, the 3.8% HI tax does not apply to trades or businesses. Examples of trades or businesses to which the 3.8% HI tax *does* apply include:

- A trade or business treated as a passive activity under IRC §469; and
- A trade or business of trading in financial instruments or commodities, as defined in IRC §475(e)(2).

Items not investment income

The Congressional Committee Reports mention certain items that are specifically excluded from investment income. (Com. Rept. ¶5052) However, these items are not meant to be the complete list of items excluded. Items mentioned in the Committee Reports are:

- Tax-exempt bond interest;
- Veterans' benefits;
- Amounts subject to self-employment tax;
  Distributions from retirement plans and IRAs (although taxable distributions would count toward the income threshold amount); and
- Excluded gain from the sale of a principal residence.

Another urban myth

Contrary to what your clients may have heard, the 3.8% additional Medicare tax does NOT apply to the sales price of a principal residence. Only the taxable gain, after the IRC §121 exclusion, will be treated as investment income.

Deductions — Prop. Treas. Regs. §1.1411-4(f)

The regulations provide that only certain deductions against investment income are allowable. Allowable deductions include:

- Deductions from rents and royalties as allowed under IRC §62(a)(4);
- Deductions allocable to passive activities and to the business of trading in financial instruments or commodities, to the extent the deductions have not been taken into account in determining self-employment income;
- The penalty on early withdrawals of savings under IRC §62(a)(9);
- Investment interest expense;
- Investment expenses;
- State, local, and foreign income taxes allocable to NIIT.

In addition, the regulations provide that carryovers of deductions for NIIT purposes are allowed in the same manner as allowed under the provisions for the regular income tax.

However, net operating loss carryover deductions are not allowed to be taken into account in determining net investment income for any taxable year. (Prop. Treas. Regs. §1.1411-4(f)(1)(ii))

NOLs

While the IRS realizes that NOLs may be generated, at least in part, by net investment losses, sorting out the amount deductible for NIIT purposes would be "unduly complex and not administrable." The IRS is welcoming comments on this matter, so it's possible the IRS could reconsider their stance. (Preamble ¶5.E)

Investment interest expense

Investment interest is allowed as a deduction to the extent allowed under IRC §163(d)(1); that is, it is allowed to the extent of net investment income as determined under IRC §163. As a result, net investment income cannot be less than zero for purposes of the NIIT. Any carryover for regular tax purposes under IRC §163(d)(2) may also be carried over for NIIT purposes. (Prop. Treas. Regs. §1.1411-4(f)(3)(A))

Example of investment interest expense limitation

In 2013, Judy pays interest on debt incurred to purchase stock. She has no investment income. She has $10,000 of income from a passive activity. She may not deduct the $4,000 interest under IRC §163(d), and it is carried forward to 2014.

In 2014, Judy has $5,000 of investment income as defined under IRC §163(d)(4). She may deduct the $4,000 carried forward interest for both income tax purposes and for NIIT purposes.

Investment expenses

Investment expenses described under IRC §163(d)(4)(C) are allowable as deductions for purposes of determining the NIIT. These deductions are subject to the 2% of AGI limitation for regular tax purposes (the IRC §67 limitation) and also for NIIT purposes. (Prop. Treas. Regs. §1.1411-4(f)(3)(B))

State, local, and foreign income taxes

Allocable state, local, and foreign income taxes that are deductible under IRC §163(a)(3) for regular tax purposes are also deductible for NIIT purposes. (Prop. Treas. Regs. §1.1411-4(f)(3)(C))

The regulations provide that the deduction must be allocated on "any reasonable basis," but strongly suggest that the deduction should be made *pro rata* on the basis of the taxpayer's net investment income as a percentage of total gross income. For example, if 20% of the taxpayer's gross income is net investment income, then 20% of the taxpayer's deduction for income taxes paid is deductible for NIIT purposes.

State taxes

Apparently, as is the case with the regular tax, the deduction for state taxes paid is the amount paid during the year, not the actual state tax for the year. However, unlike the regular tax, excess payments are not included in NIIT the following year as a state tax refund. Therefore, there doesn't seem to be anything preventing a taxpayer from "loading up" on state tax payments each year.

Foreign taxes

It is not clear how foreign taxes are handled. Prop. Treas. Regs. §1.1411-4(f)(3)(C) provides a deduction for taxes that "are deductible." Foreign taxes are deductible, but what if the taxpayer elects to take the foreign tax credit instead of the deduction? Moreover, if the taxpayer has only small amounts of foreign income with small amounts of foreign taxes paid, would "any reasonable method" include allocating all of the foreign taxes paid to the foreign income? Must the same allocation method be used for all types of deductible income taxes (state, foreign, etc.)?

The IRC §§67 and 68 limitations

Amounts deductible for NIIT purposes that are deductible as itemized deductions for regular tax purposes may be subject to IRC §67 (the 2% floor on miscellaneous itemized deductions) and/or IRC §68 (the overall limitation on itemized deductions for taxpayers above certain AGIs). The regulations provide for allocation of these limitations to items that are and are not deductible for NIIT purposes.

Note that for the three classes of itemized deductions:

- **Investment interest expense:** *neither* §67 nor §68 apply;
- **Investment expense:** *both* §67 and §68 apply; and
- **State, local, and foreign taxes:** §67 does not apply and §68 applies.

Losses limited

Because IRC §1411(c)(1)(A)(iii) uses the term net gain, the proposed regulations provide that the amount of net gain included in net investment income cannot be less than zero. (Prop. Treas. Regs. §1.1411-4(d)(2)) Thus, a taxpayer cannot use the $3,000 deduction allowance provided for regular income tax purposes under IRC §1211.

The regulations allow capital loss carryforwards, but only in the amount allowed for regular tax purposes. As a result, the $3,000 deduction allowance is lost for NIIT purposes.

Comment

This is an unpleasant surprise. A taxpayer with a $20,000 net capital loss in Year 1 gets a $3,000 deduction for regular tax purposes, but not for NIIT purposes. In Year 2, the taxpayer gets a $17,000 carryover for both regular tax purposes and NIIT purposes. For NIIT purposes, the taxpayer never gets the benefit of the $3,000.

Pre-effective-date capital loss carryovers allowed

A taxpayer may use a capital loss carryforward from a year prior to 2013 in offsetting gains derived in a year in which IRC §1411 is in effect. (Prop. Treas. Regs. §1.1411-4(h), Ex. 1)

Income from flow-through entities

According to the Congressional Research Service, taxpayers with AGIs in excess of $250,000 receive 62% of taxable income from partnerships and S corporations.

Generally, partners and S corporation shareholders must look to the nature of the flow-through item in their hands. Thus, a line item might represent investment income in the hands of one partner and not in the hands of another partner.

For partners or shareholders who are passive, the issue is simple. Since passive income is treated as investment income, all of the flow-through income is investment income.

The analysis is more complex with respect to partners and shareholders for whom their participation in the business of a partnership or S corporation represents the conduct of an active trade or business *to the partner or shareholder*. Generally, the business of the partnership or S corporation would be the conduct of an active trade or business to the partner or shareholder if the partner or shareholder materially participates in the business.

Generally, flow-through items of rent, dividends, interest, and capital gains would be investment income to an active partner or shareholder. However, it depends on whether the funds or assets generating the income represent the working capital of the partnership or corporation (see the discussion of working capital, below).

Line 1 amounts (less subtractions for line 12, IRC §179 or an IRC §743(b) adjustment) for an active partner are generally not investment income. However, such amounts are generally included on line 14 for self-employment earnings, subject to the self-employment tax and subject to the 0.9% HI tax.

The S corporation "wormhole"

Line 1 amounts from an S corporation occupy a poorly defined area in the tax law as is made clear by the disputes that arise between taxpayers and the IRS regarding whether the amount should be treated as self-employment income (see the discussion of the ***Watson*** case on page 4-28). The amount, however, should not be treated as investment income to a shareholder who is involved in the active conduct of a trade or business. Moreover, it should not be treated as earned income subject to the 0.9% tax on earned income. Note, however, that the IRS may reclassify the income as salary, in which case the income is subject to the 0.9% tax.

Working capital

For purposes of investment income derived from investment of working capital, the law provides for "a rule similar to the rule of section 469(e)(1)(B)." (IRC §1411(c)(3))

The regulations under IRC §469 state that passive activity gross income does not include portfolio income, which is defined to include interest, dividends, and capital gains. However, certain income that would otherwise be classified as portfolio income will be treated as income derived in the course of a trade or business. The two most common examples include interest earned in the business of loaning money and interest earned on accounts receivable. (Treas. Regs. §1.469-2T(c)(3))

Accordingly, income derived from the investment of working capital is generally treated as investment income with limited exceptions.

Passive activities — Prop. Treas. Regs. §1.1411-5(b)

Income from passive activities is investment income. (IRC §1411(c)(1)(A)) The term "passive activity" for NIIT purposes has the same meaning as IRC §469, which provides that a passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate. In addition, it includes any rental activity, except if the taxpayer qualifies as a "real estate professional," or if the rental activity meets the exception for short-term rentals. (IRC §§469(c)(2), 469(c)(7); Treas. Regs. §1.469-1T(e)(3)(ii)) However, see the "IRS balks on real estate professionals" that appears a few paragraphs below.

Fresh start for grouping

The passive activity grouping rules apply in determining whether the trade or business is a passive activity for purposes of the NIIT. The regulations provide rules for defining an activity for purposes of applying the passive activity loss rules ("grouping rules"). (Treas. Regs. §1.469-4)

Recognizing the heightened importance of the status of a business activity as passive or nonpassive, the regulations provide an opportunity for a taxpayer to regroup activities that the taxpayer had previously grouped. (Prop. Treas. Regs. §1.469-11(b)(3)(iv)) Generally, once a taxpayer has made a grouping election, the election cannot be revoked.

Taxpayers may make a regrouping election in any tax year that begins in 2013 or later in which NIIT would apply to the taxpayer without regard to the effect of the regrouping (the first year in which they have net investment income and the applicable income threshold is met).

A taxpayer may only regroup activities once, and any regrouping will apply to the tax year for which the regrouping is done and all later years. The regrouping must be disclosed in accordance with the requirements of Rev. Proc. 2010-13 and Treas. Regs. §1.469-4(e).

Caution

Not all passive activities can be grouped. They can only be grouped if they are an "appropriate economic unit." See Treas. Regs. §1.469-4(c)(1).

IRS balks on real estate professionals

The IRS declined to state whether real estate professional status elevates an activity to the level of a trade or business, which would make income from the activity exempt for NIIT tax purposes. Preamble ¶6.B.i(b)(2)

Stating only that "a taxpayer who qualifies as a real estate professional is not necessarily engaged in a trade or business with respect to the rental estate activities," the IRS concludes that "if the rental real estate activities of the real estate professional are not section 162 trades or businesses, the gross income from rents derived from such activity will not be excluded" for purposes of the NIIT.

Gains and losses from dispositions of partnership or S corporation interests

Gain on the sale of a partnership or S corporation interest is, presumptively, investment income. That presumption is conclusive if the interest is passive to the holder of the interest or the entity is in the business of trading in financial interests or commodities. (Prop. Treas. Regs. §1.1411-7)

However, if the taxpayer materially participates in the trade or business of the entity, the regulations provide that the taxpayer can "look through" the entity and determine his or her share of gain or loss on a hypothetical sale, or "deemed sale," of all of the entity's assets. The IRS states that Congress intended IRC §1411 to put a transferor of an interest in a partnership or S corporation in a similar position as if the entity had disposed of all of its properties and passed through to its owners their allocable shares. (Preamble ¶8; IRC §1411(c)(4))

Mechanics of deemed sale

Under the proposed regulations, a transferor computes the gain or loss from the sale of the entity's properties using a deemed asset sale method, and then determines whether, based on the deemed sale, if there is an adjustment (positive or negative) to the transferor's gain or loss on the disposition of the interest in the entity. A positive adjustment reduces a loss on the disposition of the interest, and a negative adjustment reduces gain on the disposition.

There are four steps in the hypothetical deemed sale:

- **Step 1:** A hypothetical sale of all the entity's properties, including goodwill for cash in a fully taxable transaction at FMV;
- **Step 2:** A separate computation of gain or loss on each of the entity's properties, including goodwill, by comparing the FMV of each property with its adjusted basis;
- **Step 3:** Allocation of gain or loss to the transferor of the interest based on the his or her percentage ownership and the provisions of the partnership agreement or relevant S corporation provisions; and
- **Step 4:** The determination of whether the gain or loss allocated to the transferor would have been taken into account as gain by the transferor.

The result cannot be a gain to the transferor for NIIT purposes greater than the gain for regular tax purposes and cannot result in a loss for NIIT purposes. (Prop. Treas. Regs. §1.1411-7(e))

Coordinating the 0.9% earned income tax and the 3.8% investment income tax

A taxpayer may be subject to both the 0.9% additional HI tax on earned income and the 3.8% additional HI tax on investment income.

Example of additional HI tax on both earned income and investment income

Georgia files single. In 2013, she has a salary of $220,000, interest income of $100,000, and MAGI of $290,000. Her employer withholds additional HI tax of $180 on her salary (0.9% × $20,000). Her MAGI exceeds her threshold amount by $90,000, which is less than her investment income of $100,000. As such, her additional HI tax on investment income is $3,420 (3.8% × $90,000).

MAGI	$290,000
Threshold	200,000
Excess	90,000
Investment income	100,000
Lesser of excess or investment income	90,000
Tax rate	3.8%
Additional HI tax on investment income	$ 3,420

The additional HI tax on earned income is $180 ($20,000 × 0.9%).

California nonconformity

California does not conform.