NEW 3.8% REGULATIONS — FINAL AND NEW PROPOSED

Just before the Thanksgiving holiday, the IRS issued new final regulations as well as new proposed regulations on the Net Investment Income Tax (NIIT) (the 3.8% tax on net investment income under the Affordable Care Act). They had first issued proposed regulations in December 2012. The new final regulations incorporate comments received by the IRS and finalize the tax treatment of various issues. With regard to issues in which the IRS believed there was still uncertainty, they issued new proposed regulations. The IRS acknowledged that the final NIIT regulations do not answer every question, and left the door open regarding issuance of future guidance.

The new regulations generally follow the December 2012 proposed regulations. However, there are some significant changes in several areas.

The IRS *rejected* several suggestions including:

- Underpayment penalty relief for the first year of the tax (2013): Although the IRS recognizes that the actual tax liability may not be known at the time that an estimated tax payment is due, that issue already exists with respect to the regular income tax; and
- Regrouping for those not subject to the tax: The proposed regulations provided taxpayers an opportunity to regroup their activities in the first taxable year in which the taxpayer is subject to the NIIT. The IRS rejected comments that this rule discriminates against taxpayers who are not subject to the NIIT.

Gains and losses (Page 4-8)

Delete text under subhead "Losses limited" up to subhead "Principal residence exclusion allowed."

The 2012 proposed regulations provided simply that gains and losses and associated capital loss carryforwards closely followed those for regular tax purposes, except that for purposes of the NIIT there was no allowance for the $3,000 deduction allowed for regular tax purposes (the taxpayer lost the benefit of $3,000).

The final regulations are much more generous to taxpayers but also separate the computations for regular tax purposes and NIIT purposes, making the computations and recordkeeping much more complex.

Under the final regulations, losses in excess of gains may be used to offset other investment income as a properly allocable deduction, but only to the extent the losses are allowable to reduce taxable income for purposes of the regular tax. (Treas. Regs. §1.1411-4(f)(4))

Examples of gains and losses

In 2013, George's income includes:

- $10,000 capital loss on sale of stock not from a trade or business;
- $60,000 of dividends and interest; and
- $25,000 of gains on sale of trade or business assets.

The $10,000 capital loss can offset investment income for NIIT purposes because it can be used for regular tax purposes to offset the $25,000 of gains from the trade or business property. Thus, his net investment income is $50,000.

Assume he didn't have the $25,000 of gain on the business property. In that case, since he can use $3,000 of the capital loss for regular tax purposes, he can also use $3,000 for NIIT purposes. In this case, the $3,000 capital loss allowed would reduce his investment income from $60,000 to $57,000.

Capital loss carryforwards

As capital gains and losses attributable to investment activities are separated from gains and losses generated in trade or business activities, separate computations of loss carryforwards are required. (Prop. Treas. Regs. §1.1411-4(d)(4)(iii))

The capital loss carryforward for NIIT purposes is reduced by the lesser of:

- The amount of capital loss taken into account in the current year under the regular tax; or
- The amount of net capital loss excluded from net investment income in the immediately preceding year.

Example of carryover

In 2014, Jim has a capital gain of $4,000 on the sale of stock and a $19,000 loss on the sale of assets used in a trade or business. For regular tax purposes, he has a net capital loss of $15,000. He can deduct $3,000 and has a carryforward of $12,000.

In 2015, Jim has no capital gain or loss transactions. For regular tax purposes, he can deduct $3,000 of his $12,000 carryforward and can carry $9,000 to 2016.

However, for NIIT purposes in 2015, he must adjust the carryover from 2014 by the lesser of:

- The amount of the capital loss carryfward taken into account in the current year by reason of the regular tax ($12,000); or
- The amount of net capital loss excluded from net investment income in 2014 ($19,000).

Therefore, his capital loss carryforward for NIIT purposes is zero ($12,000 carryforward reduced by $12,000).

Comment

Thus, this rule requires an adjustment only when there are excluded losses generated from a trade or business embedded in a capital loss carryforward. Thus if Jim's $19,000 loss had been from an investment loss rather than a trade or business loss, the treatment for NIIT purposes would have been the same as for regular tax purposes.

Pre-effective date carryforwards

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 and may use the entire amount of the carryforward *regardless* of whether the loss carryforwards are generated in investment activities; i.e., even if they are attributable to active trades or businesses.

NOLs (Page 4-9)

Delete sentence in the middle of the page that states, "However, net operating loss carryover deductions are not allowed to be taken into account in determining net investment income for any taxable year." Also delete comment box below that sentence entitled "NOLs."

The 2012 proposed regulations provided that, in no event, could a net operating loss deduction be taken into account in determining net investment income. The final regulations change this rule and allow an NOL deduction to the extent that the NOL is attributable to a net investment loss. (Treas. Regs. §1.1411-4(f)(2)(iv))

The applicable *loss* in any taxable year is the lesser of:

- The amount of the NOL for the loss year that the taxpayer would incur if only items of investment income subject to the NIIT and only properly allocable deductions from net investment income are taken into account; or
- The amount of the taxpayer's NOL for the year. (Treas. Regs. §1.1411-4(h))

The applicable NOL *deduction* in any taxable year is the NIIT portion of the NOL carryforward (calculated per above) multiplied by a fraction:

- The numerator of which is the NIIT NOL; and
- The denominator of which is the total NOL.

See example below under the heading of "Dispositions of passive activities."

Deduction for state, local and foreign taxes (Page 4-10)

Delete the entire discussion under the subhead "State, local, and foreign income taxes"

The original proposed regulations provided a deduction for allocable state, local, and foreign income taxes that are deductible under IRC §163(a)(3) for regular tax purposes. (Prop. Treas. Regs. §1.1411-4(f)(3)(C)) The final regulations generally retain that deduction but clarify some points missing in the proposed regulations.

The 2012 proposed regulations provided that the deduction must be allocated on "any reasonable basis," but strongly suggested 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.

The IRS declined in the final regulations to provide additional examples of "any reasonable basis."

They did clarify, however, that if a taxpayer elects to take a credit for foreign taxes paid, the taxpayer cannot take a deduction for those taxes for NIIT purposes; that is, the taxpayer may only take a deduction for foreign taxes paid for NIIT purposes if the taxpayer deducts them for purposes of the income tax. (Treas. Regs. §1.1411-4(f)(3)(B)(iii))

The proposed regulations did *not* provide for rules similar to the rules for regular tax purposes, that state tax refunds be included in income in the year received. However, the final regulations provide that the recovery or refund of an amount previously deducted will reduce the amount of the deduction in the year of recovery (that is, it will not be treated as income in the year of recovery; it will be treated as a reduction in the amount of deduction in the year of recovery) to the extent the taxpayer received a tax benefit for NIIT purposes. Moreover, the amount of the reduction in the year of recovery is based on the ratio used in the year of the deduction, even though the ratio may be different in the year of recovery.

Example of tax refund

In 2013, Frank had $120,000 of investment income and $600,000 of total income. His state tax payments were $75,000. As 20% of his total income was investment income, on a *pro rata* basis he allocates 20% of his state tax payments as a deduction for NIIT purposes.

He received no benefit from the state tax deduction for regular tax purposes due to the alternative minimum tax, but he did receive a benefit for NIIT purposes.

In 2014, he received a state tax refund of $5,000. In 2014, his investment income is 33.33% of his total income so he allocates $30,000 out of $90,000 of his state tax payments to NIIT.

Although the $5,000 refund is excluded from income in 2014 for regular tax purposes (no tax benefit due to AMT), he did get a tax benefit for NIIT purposes. Therefore, he must reduce his deduction in 2014 by the allocable state refund based on the allocation ratio used in 2013 (20% × $5,000 = $1,000). Therefore, his 2014 deduction is $29,000 ($30,000 - $1,000).

2% miscellaneous itemized deductions and Pease phaseout (Page 4-10)

Delete beginning with "The IRC §§67 and 68 limitations" through and including the examples on pages 4-11 and 4-12.

The IRS has made a substantial change to the way allocable itemized deductions are treated for purposes of the NIIT. (Treas. Regs. §1.1411-4(f)(7)) They have abandoned the *pro rata* approach under the proposed regulations in favor of an approach that treats miscellaneous itemized deductions (the deductions subject to the 2% floor under IRC §67) as allocable deductions (before applying the itemized deduction phaseout) in the amount of the <u>lesser</u> of:

- The amount of miscellaneous itemized deductions before applying the 2% reduction that is allocable to net investment income; or
- The amount of all miscellaneous deductions allowed after application of the 2% reduction.

Itemized deductions for high-income taxpayers above a specified threshold are subject to a phaseout under IRC §68. In determining the amount of net investment income, the amount of properly allocable itemized deductions subject to the IRC §68 phaseout is the <u>lesser</u> of:

- The sum of the amount determined after application of the 2% limitation plus the amount of itemized deductions (those not subject to the 2% limitation) that are properly allocable to net investment income (generally, investment interest expense); or
- The amount of all deductions allowed after application of IRC §68 (excluding itemized deductions that are not subject to phaseout, such as medical expense, casualty loss, and investment interest expense).

Example of IRC §67 and IRC §68 limitations

Brandon, an unmarried individual, has the following income in 2013. The IRC §68 applicable threshold amount is $250,000.

Salary	$1,600,000
Interest income	400,000
AGI	$2,000,000

He has the following itemized deductions:

Investment expenses	$ 70,000
Employee business expenses	30,000
Investment interest expense	80,000
State income taxes	120,000
Total	$ 300,000

His allocable state income tax is:

Investment income	20% =	400,000
Total income		2,000,000

State income taxes	$ 120,000
Allocation percentage	20%
Allocable state income tax (before IRC §68)	$ 24,000

His IRC §67 adjustment is:

AGI	$2,000,000
Threshold percentage	2%
Reduction	$ 40,000

Investment expenses	$ 70,000
Employee business expenses	30,000
Total miscellaneous itemized	100,000
Less reduction	(40,000)
After 2% limitation	$ 60,000

Under the final regulations, his deduction is $60,000 (before IRC §68 phaseout), the lesser of his investment expenses before the 2% reduction ($70,000) or the amount of all of his miscellaneous itemized deductions after the 2% reduction ($60,000).

Example of IRC §67 and IRC §68 limitations (continued)

His itemized deductions subject to IRC §68 allowed after application of IRC §67 but before application of IRC §68:

AGI		$2,000,000
Applicable IRC §68 phaseout threshold amount		(250,000)
Excess		1,750,000
Percentage reduction		3%
Amount of reduction		$ 52,500

Itemized deductions subject to phaseout after 2% reduction:

Miscellaneous		$ 60,000
State income tax		24,000
Total	**<A>**	$ 84,000

All deductions subject to phaseout:

Miscellaneous		$ 60,000
State income tax		120,000
Total		180,000
Phaseout amount		(52,500)
Difference	**<B>**	$ 127,500
Lesser of **<A>** or **<B>**		$ 84,000
Investment interest expense		80,000
Total		$ 164,000

His NIIT is:

Investment income	$ 400,000
Allocable deductions	(164,000)
Net investment income	236,000
Tax rate	3.8%
NIIT	$ 8,968

Real estate professionals (Page 4-15)

Delete text under subhead "IRS balks on real estate professionals."

In the original proposed regulations, the IRS took a balk on real estate professionals, 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 real estate activities."

Rental real estate has a double whammy against it for purposes of the NIIT. It is "Category 1 income" (rents) and it is also "Category 2 income" (passive). By meeting the requirements of a real estate professional and materially participating in any particular rental real estate activity, the taxpayer overcomes the Category 2 problem; the activity is no longer passive. As the IRS implied in the original proposed regulations, the taxpayer is still left with the Category 1 problem, and it is not clear whether the taxpayer would meet the trade or business exception. Although the taxpayer meets the material participation requirement for a trade or business, the taxpayer is left combing through decades of court decisions looking for a definition of "trade or business" only to find that it has never been decided whether rental real estate is a trade or business.

Recognizing that taxpayer can meet the requirements of a real estate professional primarily in non-rental real estate activities (e.g., construction) and meet the material participation requirements with respect to his rental real estate with minimal participation (through one of the seven tests in Treas. Regs. §1.469-5T), the IRS has provided a safe harbor that, if met, will qualify income from the rental real estate for the trade or business exception. (Treas. Regs. §1.1411-4(g)(7))

The safe harbor test provides that if real estate professional participates in any particular rental real estate activity for more than 500 hours per year or more than 500 hours in five of the last 10 years, the rental income from that rental real estate activity is treated as derived in a trade or business and meets the trade or business exception, and is therefore not included as net investment income.

Self-charged rents and self-charged interest (Page 4-15)

Add immediately above subhead "Short-term rental exception."

The final regulations provide an exception for self-charged rents and self-charged interest. (Treas. Regs. §1.1411-4(f))

Self-charged rents

Generally, self-charged rents exist when a taxpayer rents property for use in an activity in which the taxpayer materially participates. In order to avoid allowing the taxpayer to reduce ordinary income from the activity (such as K-1, line 1 income from an interest in an S corporation or partnership) while simultaneously generating passive income on the personal side, the rental income is recharacterized as nonpassive. (Treas. Regs. §1.469-2(f)(6))

The final regulations provide that, in the case of rental income recharacterized as nonpassive, the rental income is deemed to be derived in an active trade or business.

Self-charged interest

The final regulations provide that, in the case of self-charged interest received from a nonpassive entity, the amount of interest income excluded from net investment income will be the taxpayer's allocable share of the nonpassive deduction.

Certain partnership payments (Page 4-16)

New. Insert at end of page.

The new proposed regulations provide that a guaranteed payment to a partner under IRC §707(c) is excluded if received for services but included if received for capital. (Prop. Treas. Regs. §1.1411-4(g)(10))

In addition, the regulations provide lengthy analysis of IRC §736 payments. In general, IRC §736(b) payments are treated as gains from the disposition of property subject to NIIT unless the trade or business exception applies. (Prop. Treas. Regs. §1.1411-4(g)(11))

Dispositions of passive activities (Page 4-16)

Delete text under "Dispositions of passive activities" and insert test below.

When a taxpayer disposes of his or her interest in a passive activity in a complete disposition, the gain or loss from the sale is aggregated with current-year passive income and losses and carryover losses from prior years.

If the net result is a gain, it can be offset by losses from other passive activities.

If the net result is a loss and the loss exceeds the aggregate net income or gain from all other passive activities (including carryover losses), it is treated as a loss that isn't from a passive activity. (IRC §469(g)(1)(A))

In the case of a gain, it is investment income because it is passive gain.

The proposed regulations did not address a loss, although a strict reading of the rules would indicate that the loss could not be used because it was treated as nonpassive for purposes of the regular tax.

The final regulations state simply that losses allowed in computing taxable income by reason of §469(g) are taken into account, in the same manner as they are for purposes of the regular tax. (Treas. Regs. §1.1411-(g)(9)) The IRS recognizes that §469(g) losses allowed by reason of the disposition of the passive activity are allowed in full because they represent true economic losses.

Comment

A complete disposition of a passive activity at a loss might be the most likely means by which a taxpayer generates an NIIT NOL.

Example of complete disposition of passive activity and NOL

Bob disposes of a passive activity with a loss of $250,000. He has $100,000 of suspended losses from the activity. He owns no other passive activities.

He also has W-2 income of $300,000 and $5,000 of interest income.

Since his passive loss of $350,000 is incurred in a complete disposition, it is treated as nonpassive for purposes of the regular tax. He may use the entire amount to offset his investment income of $5,000 — meaning he has negative investment income of $345,000.

His net operating loss for regular tax purposes is $50,000. The lesser of his negative investment income or his NOL for regular tax purposes is $50,000. Therefore, he has an NOL for NIIT purposes of $50,000.

Carryforward/carryback

The regulations do not address whether carrybacks are allowed or whether a taxpayer may make independent elections with respect to the regular tax and the NIIT.

Dispositions of interests in partnerships and S corporations (Page 4-17)

Delete entire two-page discussion under "Dispositions of interests in partnerships and S corporations – Prop. Treas. Regs. §1.1411-7" and insert the text below.

The original proposed regulations provided that any gain on the sale of an interest in a partnership or S corporation was presumptively investment income for purposes of the NIIT. The taxpayer could overcome this presumption with respect to some or all of the gain by using a look-through deemed-sale approach similar to that required under IRC §751 for purposes of the regular tax.

Recognizing that the issue is complex, the IRS withdrew the previously issued Proposed Regs. under §1.1411-7 and issued new proposed regulations on the issue. The new proposed regulations continue to employ the deemed-sale approach but also provide a simpler alternative method.

Comment

Keep in mind that these rules are only applicable if the taxpayer is active (materially participates) in the business. If not, the gain is passive income and is, therefore, "Category 2" income subject to the tax.

Under the new regulations, the analysis is reversed. Rather than prove the amount that is not subject to the tax, the amount of net gain on the sale of an interest that is treated as investment income is the *lesser* of:

- The overall gain or loss on the sale of the interest; or
- The gain attributable to investment income. (Prop. Treas. Regs. §1.1411-7)

Example of sale of interest

Alex sells her partnership interest in Taxes 'r Us, an accounting and tax preparation practice. She has always materially participated in the business. Her gain on the sale of the interest is $100,000 and she is a 50% partner. Since she materially participates, under the simplified method the gain is presumptively trade or business gain. However, at the time of the sale, the partnership holds marketable securities with built-in appreciation of $10,000. As a 50% owner, $5,000 of that unrealized gain is attributable to her and is attributable to investment income.

The lesser of the overall gain or the gain attributable to investment income is $5,000. Her investment income on the sale is $5,000.

Simplified optional method

Although the standard method is vastly simplified from the 2012 proposed regulations, it still contains one major flaw: the partner or shareholder is dependent on the entity to provide the necessary information and the entity, in turn, is burdened with reporting requirements.

An eligible owner may use the simplified optional method. Under this method, the amount of gain or loss on a sale attributable to investment income is based on the historic percentage of total income allocated to the partner or shareholder that is investment income. By "historic," the regulations refer to the "Section 1411 Holding Period" which is the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less. (Prop. Treas. Regs. §1.1411-7(a)(2)(iii))

An eligible owner, generally, is one whose gain on sale is less than $250,000 or one whose (1) gain is less than $5,000,000, and (2) at all times during the Section 1411 Holding Period was a less-than-5% owner.

Required statement

Any transferor applying Prop. Treas. Regs. §1.1411-7 must attach a statement to the transferor's return for the year of disposition including the following information:

- The taxpayer's name and identification number;
- The name and identification number of the entity in which the interest was transferred;
- The amount of gain or loss on the disposition of the interest for regular tax purposes; and
- The amount of adjustment to gain or loss for purposes of the NIIT.

Information reporting by entity

The passthrough entity must provide the transferor with the information needed to compute the transferor's allocable share of gain or loss from Section 1411 property unless the transferor is eligible to use the simplified optional method.

SHORT SALE OF CALIFORNIA PRINCIPAL RESIDENCE MAY NOT RESULT IN COD

Ever since California enacted the anti-deficiency provision under Code of Civ. Proc. §580e, pundits have argued over whether COD results from the release of liability in the short sale of a principal residence. At the request of California Senator Barbara Boxer, the IRS has opined in a Chief Council letter dated September 19, 2013, that the short sale of a California principal residence converts the mortgage to a nonrecourse loan and is treated as a sale, not COD.

Here's how it works.

A short sale involves a sale of property for less than the outstanding mortgage loan balance. When an owner enters into a short sale, the lender may hold the owner personally liable for the difference between the loan balance and the sales price if the loan was recourse.

In 2010 and 2011, California enacted an anti-deficiency provision, which generally prohibit a lender who holds a deed of trust on a dwelling of four units or less from either claiming a deficiency or obtaining a deficiency judgment from the homeowner after agreeing to a short sale. SB 931 ((Ch. 10-701), effective January 1, 2011) applied to first trust deeds only. SB 458 (Ch. 11-82) extended the provision to second mortgages and was effective July 15, 2011.

The statute effectively limits the homeowner's liability to the amount the lender received on the sale of the principal residence, and the homeowner is not personally liable for the deficiency balance (the difference between the loan balance and the sales price).

The letter states that the IRS believes that a homeowner's obligation under the anti-deficiency provision of Code of Civ. Proc. §580e would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have COD income. Instead, the homeowner must include the full amount of the nonrecourse indebtedness in the amount realized.

Caution

We see two potential problems with this letter:

- The IRS letter is not substantial authority and can be revoked at any time. There are folks who argue that the IRS position is incorrect and have gone so far as to request the IRS reconsider their position; and
- The letter refers to California's legislation as applying to "principal residence" but the law actually refers to "dwellings of four units or fewer." This leaves a question as to whether the analysis applies to only principal residences or to residential property of four or fewer units.

We will keep you posted of any further changes. You may see a copy of the letters at:

Websites

Senator Boxer's letter: www.caltax.com/spidellweb/public/editorial/Boxershortsaleletter.pdf
IRS's response letter: www.caltax.com/spidellweb/public/editorial/IRSresponseletter.pdf

California

Because California conforms to IRC §108, with certain unrelated exceptions, California will conform to the IRS letter. (R&TC §17024.5)

Amend

If your client reported COD on the short sale of a principal residence on or after January 1, 2011, you may want to consider filing an amended return to treat the short sale as a sale of the property rather than COD.

Example of short sale

Jerry purchased his principal residence for $300,000 and placed a mortgage of $240,000. He subsequently refinanced the property and had a mortgage of $500,000 and a fair market value of $400,000 when he stopped making the payments.

If he negotiates a short sale with the lender, he will treat the disposition as a sale.

Sales price	$500,000
Basis	(300,000)
Gain	$200,000

The gain is excludable under IRC §121.