

3.8% Federal Net Investment Income Tax Challenges for Tax Professionals

Tackling Tax Compliance and Planning for High-Income Individuals and Pass-Through Entities

THURSDAY, SEPTEMBER 18, 2014, 1:00-2:50 pm Eastern

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3.8% Federal Net Investment Income Tax Challenges for Tax Professionals

Sept. 18, 2014

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3.8% Federal Net Investment Income Tax Challenges for Tax Professionals

Mechanics and Thresholds of the 3.8% NII Tax

By Mitchell S. Fuerst, Esq.



Introduction to the New 3.8% Tax

- The Healthcare and Education Reconciliation Act of 2010 added a new chapter 2A to the Code.
- Section 1411 imposes a 3.8% tax on net investment income of an individual whose modified adjusted gross income (MAGI) exceeds certain thresholds.



Section 1411: Surtax on Net Investment Income

For 2014, high-income individuals will pay an extra 3.8% tax on the lesser of:

- Net investment income, or
- Modified adjusted gross income (“MAGI”) – the applicable threshold:
 - **\$250,000 for MFJ**
 - **\$200,000 for single**
 - **\$125,000 for MFS**

Modified Adjusted Gross Income

Adjusted gross income (i.e. Form 1040, Line 37) PLUS Net foreign earned income exclusion (under Section 911(a)).



Definition of Net Investment Income:

Net investment income categories:

1. Interest, dividends, annuities, royalties, rents, substitute interest and dividend payments, and income from working capital.
2. Income and gains from S corporations, partnerships, and sole proprietorships if they are “passive activities”.
3. Income and gains the trade or business of trading in financial instruments or commodities.
4. Net gains from the sale of property, including the sale of stock in an S corporation or an interest in a partnership.

Example 1:

X and Y, married filing jointly, together have income of \$500,000, all of which is salary. The surtax will not apply because they have no net investment income.

Example 2:

X and Y, married filing jointly, have \$500,000 of salary and \$50,000 of net investment income. The surtax applies to the \$50,000 of net investment income because it is less than the excess of MAGI over the threshold (i.e. \$550,000 - \$250,000 = \$300,000).

Example 3:

X a single filer, has \$275,000 of net investment income and no other income. The surtax applies only to the \$75,000 that exceeds the \$200,000 threshold for single filers.



Example 4:

X and Y, married filing jointly, have \$225,000 of salary income and \$125,000 of net investment income. The surtax applies to \$100,000, the difference between their threshold (\$250,000) and MAGI (\$350,000), which is less than their net investment income of \$125,000.

Example 5:

X a single filer, has \$500,000 of interest and a \$500,000 net capital loss. The surtax applies to \$297,000, \$500,000 less \$200,000 threshold and the \$3,000 maximum capital loss that may offset ordinary income.



The key concept of Section 1411 is the definition of the new tax base.

Effectively Congress created a separate or 2nd tax base which parallels both the calculation of taxable income taxable at regular rates, and AMT income to which rates of 26% or 28 % apply.

Brief Overview - Estate & Trusts

Application to Estates and Trusts – the new Medicare surtax is equal to 3.8% times the lesser of the following:

- Undistributed “net investment income” for such taxable year; or
- The excess (if any) of:
 - “Adjusted gross income” (as defined in Section 67(e)) for such taxable year, over the
 - Dollar amount at which the highest tax bracket in Section 1(e) begins for such as taxable year (\$11,950 in 2014)
- Charitable Remainder Trusts and tax exempt trusts under IRC Section 501 not subject to Medicare Surtax.



Planning Around the “Surtax”: Strategies for Reducing “Net Investment Income”

Trust/Estate Distribution Example:

During the 2014 tax year, the Jones Family Trust had \$100,000 of net investment income and \$19,900 of deductible expenses. The trustee is now trying to decide if a distribution of trust accounting income should be made to the trust beneficiaries. Assuming that each of the trust beneficiaries is currently in the 15% tax bracket and each has gross income below the Medicare surtax “threshold amount”, below is a summary of the tax savings that would occur if an \$80,000 distribution was made:



	No Distribution	\$80K Distribution
Gross Income	\$ 100,000	\$ 100,000
Less: Deductible Expenses	(19,900)	(19,900)
Adjusted Total Income	\$ 80,100	\$ 80,100
Less: Income Distribution Deduction	-	(80,000)
Less: Exemption	(100)	(100)
Taxable Income	\$ 80,000	\$ -
Income Tax @ Trust Level	\$ 30,407	\$ -
Income Tax @ Beneficiary Level	-	12,000
Total Income Tax	\$ 30,407	\$ 12,000
Medicare Surtax @ Trust Level	\$ 2,614	\$ -
Medicare Surtax @ Beneficiary Level	-	-
Total Medicare Surtax	\$ 2,614	\$ -
Total Taxes	\$ 33,021	\$ 12,000
SAVINGS		\$ 21,021



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Planning Around the “Surtax”: Strategies for Reducing “MAGI”

- Qualified and Non-Qualified Income Deferrals
- Roth IRA conversions
- Charitable remainder trusts (CRTs)
- Non-grantor charitable lead trusts (CLTs)
- Installment sales
- Defer Receipt of Social Security Benefits
- Life Insurance
- Rental Real Estate (Safe Harbour)
- Municipal Bonds



Planning Around the “Surtax”: Strategies for Reducing “MAGI”

- **Qualified and Non-Qualified Income Deferrals**
 - Review employer retirement plan options
 - Defer Wages to 401(K) - \$17,500 (Additional \$5,500 for those over age 50)
 - Defined Contribution/Defined Benefit Plans for Self-Employed Individuals
 - Non-Qualified Deferred Compensation
 - Tax Deferred Growth
 - Reduces AGI below “Threshold Amount” in year of deferral, take distributions in years when AGI is lower



Planning Around the “Surtax”: Strategies for Reducing “MAGI”

- **Roth IRA Conversions**
 - Roth IRA Benefits
 - Tax-free compounding
 - No RMDs at age 70½
 - Tax-free withdrawals for beneficiaries
 - Can lower MAGI below the “Threshold Amount” over the long-term.



Planning Around the “Surtax”: Strategies for Reducing “MAGI”

- **Roth IRA Conversions**
 - Critical decision factors
 - Tax rate differential (year of conversion vs. withdrawal years)
 - Use of “outside funds” to pay the income tax liability
 - Need for IRA funds to meet retirement living expenses
 - Will estate be subject to federal estate taxes
 - Time horizon

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3.8% SURTAX ON TRUSTS & ESTATES

CPE Webinar – Tax Challenges for Tax Professionals



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EXPERT WITNESS | TRUST, ESTATE & TAX MATTERS



INTRODUCTION

- ▶ Most of the tax increases in the **American Tax Relief Act of 1012 (ATRA)** were aimed at the wealthiest taxpayers. Unfortunately, the tax increases hit trusts and estates with an extra punch.



THE TAX CHANGES



- ▶ **First**, the Patient Protection and Affordable Care Act (often called “Obamacare”) imposes a 3.8% surtax on “net investment income” (NII).



▶ “NET INVESTMENT INCOME” generally is the passive investment income earned by a trust or estate and consists of three categories:

1. Gross income from interest, dividends, annuities, royalties and rents (other than income derives in the ordinary course of a non-passive business other than trading in financial instruments or commodities)
2. Gross income from a passive activity or a trade or business of trading in financial instruments or commodities.
 - “*Passive activity*” is a trade or business in which the taxpayer does not “materially participate.”
3. Net gain to the extent taken into account in computing taxable income (such as capital gain).



NET INVESTMENT INCOME

Net Investment Income does *not* include:

1. Qualified pension, profit sharing and stock bonus plans
2. Qualified annuity plans
3. Annuities for employees of tax-exempt organizations and public schools
4. IRAs – both traditional and Roth
5. Deferred compensation plan of state and local governments and tax-exemption organizations
6. Nonqualified deferred compensation (not exempt in statute but introduction to proposed regulations so indicate)



THE TAX CHANGES

- ▶ **Second**, the top income tax rate went up from 35% to 39.6% and the maximum rate on dividends and capital gains is 20%, up from 15% in 2012. (Meaning the combined rate with the surtax will be 23.8%)



APPLIES TO TRUSTS AND ESTATES



- ▶ Section 1411 of the Internal Revenue Code (“IRC”) imposes the surtax on individuals, trusts and estates.
 - *Specifically* the trusts to which it applies are trusts subject to the provisions of Part I of Subchapter J of Chapter I of Subtitle A of the IRC

Exceptions: Does not apply to business trusts, common trust funds, designated settlement funds, pooled income funds, cemetery perpetual care funds, qualified funeral trusts, or Alaska Native Settlement Trusts





THE COLLATERAL DAMAGE

WHY ARE TRUSTS AND ESTATES HIT SO HARD?

- The trust and estate income tax brackets are compressed. For individuals, the 3.8 % Obamacare surtax doesn't hit until a taxpayer's net investment income is more than \$200,000 a year (\$250,000 for a married couple filing jointly). For trusts and estates, the surtax hits when net investment income is over \$12,150 (for 2014).

Filing Status	Surtax Threshold
Married filing jointly	\$250,000
Single, Head of Household	\$200,000
Married filing separately	\$125,000
Trusts and Estates	\$12,150

THE COLLATERAL DAMAGE



- ▶ The top income tax rate of 39.6% doesn't apply to individuals until income is over \$400,000 (\$450,000 for joint). A trust hits the 39.6% top bracket when trust income is over \$12,150.
- ▶ If a trust's income is over \$12,150, then it falls into the 39.6% top bracket *and* gets hit with the 3.8% surtax, bringing combined taxes to 43.4%.
- ❖ OUCH, that hurts. \$12,150 is not very much income..



DISTRIBUTABLE NET INCOME (DNI)

- ▶ To determine whether a trust has retained or distributed income, the fiduciary must compute Distributable Net Income.
- ▶ Now the fiduciary must also track whether items of DNI are NII. The beneficiary includes distributed NII in his or her 1040 NII.

DISTRIBUTABLE NET INCOME (DNI)

- ▶ FIDUCIARY INCOME TAX RETURN IS A HYBRID
 - To the extent that the fiduciary's income is retained during the year, it is taxed to the estate or trust. To the extent the income is distributed, the estate or trust is merely a conduit to the taxpayer. Distributees must include in gross income all distributions to the extent of "Distributable Net Income."
 - How much income is distributed is determined by calculating DNI.



DISTRIBUTABLE NET INCOME (DNI)

- ▶ DNI is a generally taxable income with modifications
- ▶ The tax liability of a trust or estate is generally allocated among the fiduciary and the income beneficiary according to the allocable share of DNI.
 - DNI determines the character of the distributions to the beneficiaries
- ▶ DNI consists of the taxable income of an estate or trust before deductions for distributions to beneficiaries





DISTRIBUTABLE NET INCOME

DNI IS INCREASED BY

1. Tax-exempt interest
2. The deduction for personal exemption
3. Any deduction for capital losses

DNI IS DECREASED BY

1. The amount of capital gains (unless capital gains are required to be distributed or properly allocated to income)
2. The amount of extraordinary dividends or taxable stock dividends that the fiduciary allocates to corpus



EXAMPLE 1

SEE EXAMPLE 1 FROM TREAS REG. §1.1411-3(e)

For this example, consider a Trust that has the following income (and no expenses):

Dividends	\$15,000
Interest	\$10,000
Capital Gain	\$5,000
IRA Distributions	\$75,000



EXAMPLE 1

SEE EXAMPLE 1 FROM TREAS REG. §1.1411-3(e)

Trustee distributes \$10,000 of trust accounting income to Beneficiary A.

	Taxable Income	DNI	NII
Dividends	\$15,000	15,000	15,000
Interest	\$10,000	10,000	10,000
Capital Gain	\$5,000		5,000
IRA Distributions	<u>\$75,000</u>	<u>75,000</u>	<u>0</u>
TOTAL	\$105,000	100,000	30,000



EXAMPLE 1

SEE EXAMPLE 1 FROM TREAS REG. §1.1411-3(e)

Trust's distribution deduction is \$10,000. Under Treas. Reg. §1.662(b)-1, the distribution deduction reduces each class of income comprising DNI on a proportional basis. The \$10,000 distribution is 10% of DNI.

	Beneficiary Distribution	NII Distributed	Trust's Net NII	Trust's Net Taxable Income
Dividends	\$1,500	1,500	13,500	13,500
Interest	\$1,000	1,000	9,000	9,000
Capital Gain	0	0	5,000	5,000
IRA	<u>\$7,500</u>	<u>0</u>	<u>0</u>	<u>67,500</u>
TOTAL	\$10,000	2,500	17,500	95,000



EXAMPLE 2

SEE EXAMPLE 2 FROM TREAS REG. §1.1411-3(e)

Same income as Example 1 above. Trust is required to distribute \$30,000 to Beneficiary A. Trust has a \$10,000 charitable deduction. Trustee makes a discretionary distribution of \$20,000 to Beneficiary B.

	Beneficiary A Distribution	NII Distributed to Beneficiary B
Dividends	\$4,500	4,500
Interest	\$3,000	3,000
Capital Gain	0	0
IRA	<u>\$22,500</u>	<u>0</u>
TOTAL	\$30,000	7,500



EXAMPLE 2

SEE EXAMPLE 2 FROM TREAS REG. §1.1411-3(e)

The \$10,000 distribution to charity takes out 10% of the DNI of the trust pro rata against each category of income. The income is not passed out to the charity via a K-1, but it has the same result on DNI and NII as if it did.

What happens to DNI in Example 2:

	Total DNI	K-1 to A	Charity "Distribution"	K-1 to B	Trust's Portion
Dividends	\$15,000	4,500	1,500	3,000	6,000
Interest	\$10,000	3,000	1,000	2,000	4,000
Capital Gain	0	0	0	0	0*
IRA	<u>\$75,000</u>	<u>22,500</u>	<u>7,500</u>	<u>15,000</u>	<u>30,000</u>
TOTAL	\$100,000	30,000	10,000	20,000	40,000

*Capital Gain is taxable to trust but not as part of DNI



DOWNSIDE FOR A BENEFICIARY

1. Phase-outs of itemized deductions and personal exemptions
2. Phase out for Roth IRA contribution or conversion
3. Deductibility of Contributions to traditional IRA
4. Medicare Part B and D premium increases
5. Taxability of Social Security
6. 7-1 / 2% floor on deductibility of medical expenses
7. 2% floor on miscellaneous itemized deductions
8. \$25,000 passive loss deduction phase-out and more..

EXAMPLE 2

SEE EXAMPLE 2 FROM TREAS REG. §1.1411-3(e)



What happens to NII in Example 2:

	Total DNI	K-1 to A	Charity "Distribution"	K-1 to B	Trust's Portion
Dividends	\$15,000	4,500	1,500	3,000	6,000
Interest	\$10,000	3,000	1,000	2,000	4,000
Capital Gain	\$5,000	0	0	0	5,000
IRA	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
TOTAL	\$30,000	\$7,500	\$2,500	\$5,000	\$15,000



TAXING INCOME TO BENEFICIARIES

1. Highest income tax bracket is 39.6% , and because of the compressed brackets, starts at \$12,150 for trusts and estates.
2. 20% maximum capital gains rate applies to trusts and estates at a *much* lower threshold than individuals
3. The 3.8% Medicare surtax will apply to most long-term capital gains.





RATE DIFFERENTIAL

- ▶ For a Trust with \$50,000 of taxable income and a beneficiary who has \$150,000 of income, the rate differential on ordinary income could be 28% for the beneficiary and 43.4% for the trust (39.6% + 3.8%). That's a 15.4% difference for ordinary income.
- ▶ The rate differential for capital gains would be 15% for the beneficiary and 23.8% for the Trust. That's an 8.8% difference for capital gains.



UPSIDE FOR A BENEFICIARY

1. Increased charitable deduction threshold
2. Possible larger net investment interest deduction
3. If subject to AMT, top rate is 28%



TAXING CAPITAL GAINS TO BENEFICIARIES



A huge “thank you” to John R. Goldsbury, U.S. Trust, Bank of America Private Wealth Management. I highly Recommended, his article titled:

“Dealing with the 23.8% tax on trust capital gains: 21 ways (and counting) to have a trust’s capital gain taxed to the beneficiary”

It was published as part of the materials for the 48th Annual Heckerling Institute on Estate Planning, published by LexisNexis Matthew Bender.
You can find the article on his Linkedin Page.

GOLDSBURY'S 21 WAYS TO TAX CAPITAL GAINS TO BENEFICIARIES



1. The capital gains are allocated to fiduciary accounting income by the Trust document
2. Unitrust: the capital gains are allocated to fiduciary accounting income by the terms of the Trust
3. Capital gains are allocated to fiduciary accounting income by state law
4. Unitrust: the capital gains are allocated to fiduciary accounting by state law
5. Capital gains are allocated to income by exercise of discretion granted under state law: the exercise of a power of adjustment under the UPIA
6. Capital gains are allocated to income by exercise of a discretionary power granted by the Trust document



GOLDSBURY'S 21 WAYS TO TAX CAPITAL GAINS TO BENEFICIARIES

7. Unitrust: the capital gains are allocated to fiduciary accounting income by reason of the exercise of discretion granted by state law
8. Unitrust: the capital gains are allocated to fiduciary accounting income by reason of the exercise of discretion granted by the Trust document
9. Discretionary distributions of principal per discretion granted by state law
10. Discretionary distributions of principal per discretion granted by the Trust document
11. Discretionary distributions of gain from sales of “certain specified assets” or a “particular class of investments” – a variation on #9 and #10

GOLDSBURY'S 21 WAYS TO TAX CAPITAL GAINS TO BENEFICIARIES



12. Capital gains from sales to fund the payment of “step outs” mandated by the Trust document
13. Interim step outs – but selling more than you need
14. Distributions in kind to meet income or unitrust distribution obligations
15. Discretionary distributions in kind, with a 643 election to recognize gain
16. “Utilizing” the amount of capital gain to determine principal distributions
17. Utilizing *proceeds* of asset sales to determine distributions



GOLDSBURY'S 21 WAYS TO TAX CAPITAL GAINS TO BENEFICIARIES

18. Utilizing proceeds of asset sales to determine *discretionary* distributions
19. Discretionary distributions in kind that do not trigger gain
20. Investing via a flow through entity, such as a partnership or an LLC
21. Causing part of the trust to be a “grantor” trust



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POTENTIAL ISSUES FOR BUSINESS TAXPAYERS AND INVESTORS IN BUSINESSES

PASSIVE VS. ACTIVE ACTIVITIES

JON BROSE
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Introduction

- What Types of Businesses Are Potentially Subject to the Net Investment Income Tax (“NIIT”) imposed by section 1411?
 - Sole Proprietorships.
 - Businesses conducted through tax partnerships (e.g., LLCs, LLPs, LPs, GPs).
 - Businesses conducted through S corporations.
- NIIT does not apply to businesses conducted through C corporations.

Ordinary Course of a Trade or Business Exception

- NIIT does not apply to gross income from interest, dividends, annuities, royalties and rents (“gross investment income”) that are excluded under the so-called “ordinary course of a trade or business exception”.
- The exception excludes such income if it is derived in the ordinary course of a trade or business, other than a trade or business:
 - That is a passive activity with respect to the taxpayer; or
 - That is derived in the trade or business of a trader trading in financial instruments or commodities (a “trading business”).
- Whether a business is a trade or business for purposes of the exception will be determined in accordance with the meaning of trade or business under section 162.

Ordinary Course of a Trade or Business Exception (Cont')

- Section 1411 does not define “ordinary course” but refers to case law and Reg. section 1.469-2T(c)(3)(ii).
 - Reg. sections 1.469-2T(c)(3)(ii) and (iii) provide that royalties can only be derived in the ordinary course of a trade or business if the licensor:
 - Created the property; or
 - Performed substantial services or incurred substantial costs with respect to the development or marketing of the property.
- Further, net gain does not include gain or loss attributable to property held in a trade or business, other than a trade or business that is a passive activity to the taxpayer or that is a trading business.
 - A partnership interest or S corporation stock generally is not considered to be property held in a trade or business.

Ordinary Course of a Trade or Business Exception (Cont’)

- Thus, if a taxpayer is engaged in or participates in a trade or business through a partnership or S corporation (a “pass-through entity”), the gross investment income and gains derived by the taxpayer from such business should only be subject to NIIT if the business is either a trading business or is a passive activity as to the taxpayer.
 - Such income, may, however, be subject to self-employment tax instead.

Ordinary Course of a Trade or Business Exception (Cont')

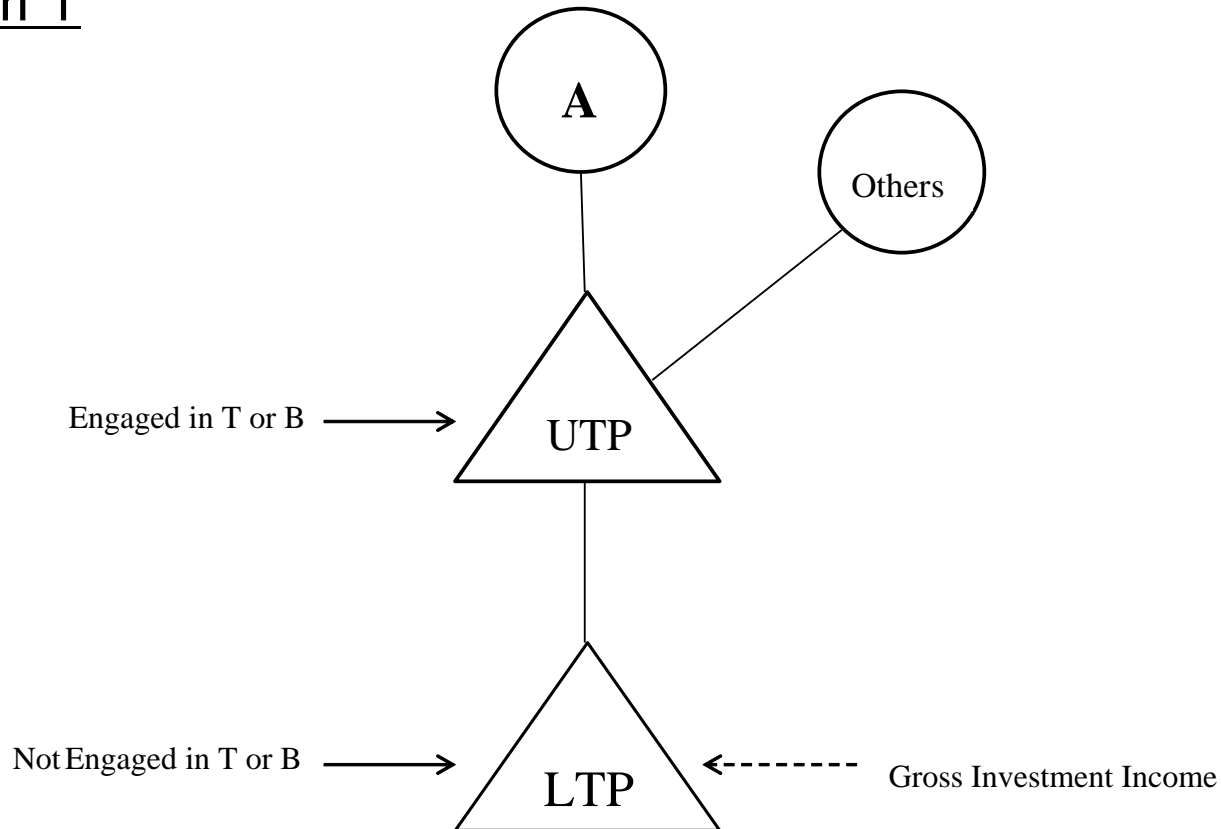
- Rules for determining whether the exception applies.
 - In the case of an individual, estate or trust that owns or engages in a trade or business directly (or through a disregarded entity), the determination of whether gross investment income is derived in a trade or business is made at the individual, estate, or trust level.
 - In the case of an individual, estate, or trust that owns an interest in a pass-through entity, the determination of whether gross investment income is:
 - A passive activity to the taxpayer is made at the owner level; and
 - Derived in a trading business is made at the entity level.

Ordinary Course of a Trade or Business Exception (Cont')

- Example 1: Individual A owns an interest in upper-tier partnership (“UTP”), which is engaged in a trade or business. UTP owns an interest in lower-tier partnership (“LTP”), which is not engaged in a trade or business. A is allocated \$5000 of gross investment income derived by LTP but which is allocated to A through UTP.
 - The \$5000 is not derived in a trade or business because LTP is not engaged in a trade or business. That the income flows to A through UTP, which is engaged in a trade or business, does not change this result. Therefore, the exception does not apply and the \$5000 is subject to NIIT. [see diagram 1]

Ordinary Course of a Trade or Business Exception (Cont')

Diagram 1

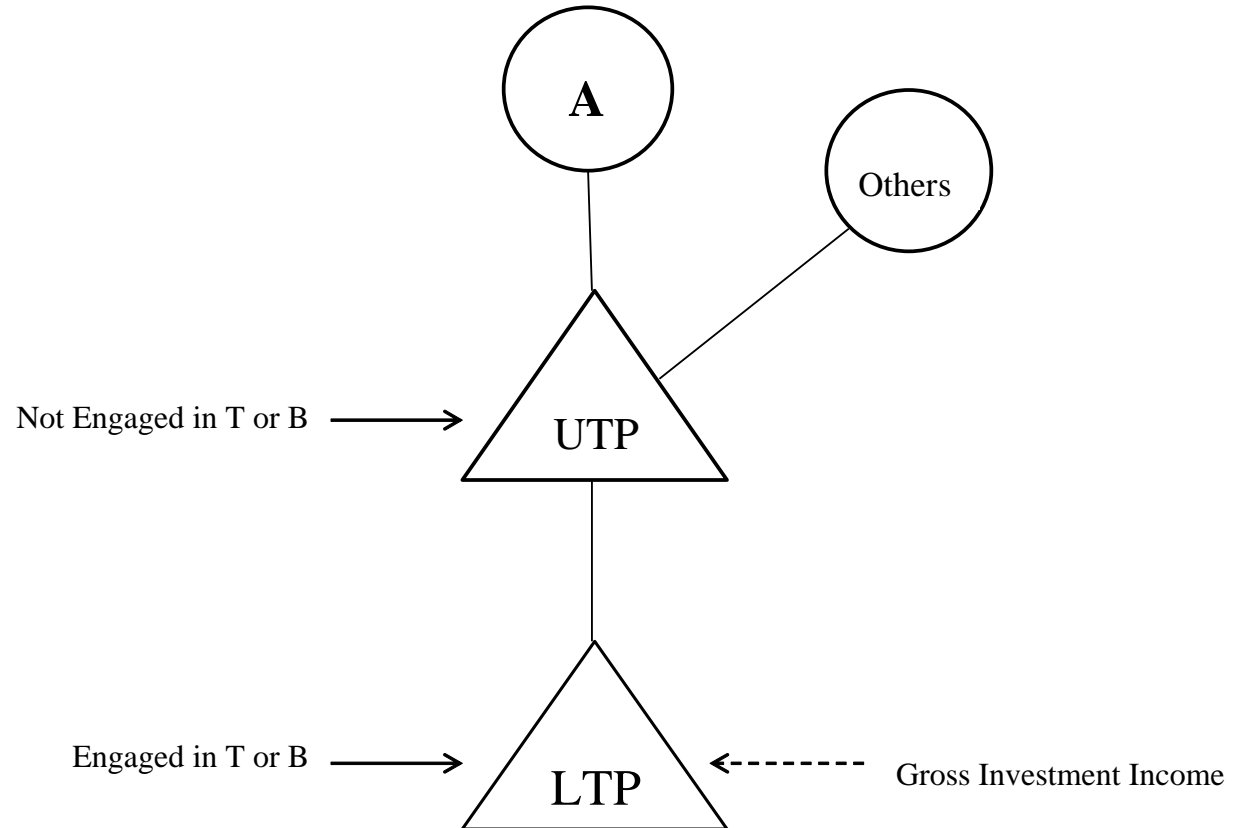


Ordinary Course of a Trade or Business Exception (Cont')

- Example 2: Individual A owns an interest in UTP, which is not engaged in a trade or business. UTP owns an interest in LTP, which is engaged in a commercial lending business. LTP's business is not passive to A nor is it a trading business. LTP allocates \$5000 of interest income earned in its business to A through A's interest in UTP.
 - The exception does apply to the \$5000 interest income allocated to since it was derived from an entity that is engaged in a trade or business. That the income flows to A through LTP, which is not engaged in a trade or business, does not change this result. Therefore, the \$5000 is not subject to NIIT.

Ordinary Course of a Trade or Business Exception (Cont')

Diagram 2



Trading Business

- A trading business consists of trading in financial instruments or commodities.
 - Financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of interest in any of the foregoing.
 - An “evidence of an interest” includes short positions or partial units.
- Commodities refers to items described in section 475 (e)(2).

Trading Business (Cont')

- Remember that section 1411 follows section 162 in determining whether an activity rises to the level of a trade or business.
 - The case law under section 162 regarding what constitutes being a “trader”, as opposed to merely an “investor” is voluminous and varies widely in factual application, but generally speaking requires a very high level of trading activity to be considered to be a trader.
- Example: Individual A owns an interest in partnership PRS, which is engaged in a trading business. PRS’ trade or business is not a passive activity with respect to A. In addition, A is not directly engaged in a trading business. PRS earns interest in a taxable year and \$5000 of such interest is allocated to A. Because PRS is engaged in a trading business, the ordinary course exception does not apply and A’s \$5000 share will be subject to NIIT.

Income on Investment of Working Capital

- Any income, gain or loss which is attributable to an investment of working capital is treated as not arising in the ordinary course of a trade or business
 - Working capital is not defined but generally refers to capital set aside for use in and the future needs of a trade or business.
 - This income is subject to the NIIT even if generated in an otherwise trade or business.
 - No deductions are generally allocated to this type of income.

Exception for Self-Employment Income

- Net investment income generally does not include items taken into account in determining self-employment income that is subject to the self-employment tax.
 - For this purpose, “taken into account” means income included and deductions allowed in determining net earnings from self-employment.
 - Amounts excepted in determining net earnings from self-employment under section 1402(a)(1)–(17) are not considered to have been taken into account and thus may be subject to NIIT.

Exception for Self-Employment Income (Cont')

- Special rule for Traders:
 - For taxpayers engaged in a trading business, the deductions described in Reg. section 1.1411-4(f)(2)(ii) will be taken into account for purposes of section 1411 only to the extent that such deductions did not *reduce* the taxpayer's net earnings from self-employment.
 - This special rule is essentially an ordering rule for traders to apply deductions from a trading business first against net earnings from self-employment before applying them to reduce NIIT. This is true even if the trader is engaged in another non-trading business that generates self-employment earnings.

Net Operating Losses

- There are three steps for determining the amount of net operating losses (“NOLs”) that can be applied to reduce net investment income:
 - First, determine the “applicable portion” of an NOL for a taxable year.
 - The applicable portion of an NOL is the lesser of:
 - The amount of the NOL for the loss year that the taxpayer would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account in determining such NOL; and
 - The amount of the taxpayer’s NOL for the loss year.

Net Operating Losses (Cont')

- Second, determine the “section 1411 amount” of an NOL carried from a previous year for a taxable year.
 - The section 1411 amount of each NOL that is carried from a loss year that is allowed as a deduction is the total amount of such NOL carried from the loss year allowed as a deduction in the taxable year multiplied by a fraction (A) the numerator of which is the applicable portion of the NOL for that loss year and (B) the denominator of which is the total amount of NOL for the same loss year.
- Third, determine the “total section 1411 NOL amount” of an NOL deduction.
 - The total section 1411 NOL amount is determined by adding together the section 1411 NOL amounts of each NOL carried to and deducted in the taxable year.

Net Operating Losses Example

Year 1: Individual A has the following items of income and deduction.

Income/(Loss) Items	\$ Amounts
Wages	\$200,000
Trading Income	\$50,000
Dividends	\$10,000
Trading Losses	\$(250,000)
Non-Business Investment Expenses	\$(12,000)
Business Losses	\$(1,000,000)
Total NOLs for Year 1	\$(1,000,000)

Net Operating Losses Example (Cont')

- Step 1: Determine the Applicable Portion

NIIT Income/(Loss) Items	\$ Amounts
Trading Income	\$50,000
Trading Losses	\$(250,000)
Applicable Portion	\$200,000

- Step 2: Section 1411 Amount of Year 1 NOL

Fraction is $\$200,000 / \$1,000,000 = .2$

Multiplied by $\$1,000,000 = \$200,000$

Net Operating Losses Example

Year 2: A has the following items of income and deduction.

Income/(Loss) Items	\$ Amounts
Wages	\$250,000
Business Income	\$300,000
Trading Losses	\$(10,000)
Total	\$(540,000)

- For chapter 1 purposes, A deducts \$540,000 of the NOL carried over from year 1.
- The section 1411 NOL amount of this is \$108,000 ($\$540,000 \times .2$)
- However, there is no investment income tax since the taxpayer's adjusted modified gross income is zero (due to the NOL).
 - Note that this \$108,000 section 1411 NOL is now permanently lost.
- The amount of the Year 1 NOL carried to Year 3 is \$460,000.
- The \$460,000 carryover to Year 3 includes a section 1411 NOL amount of \$92,000 ($\$460,000 \times .2$).
- The \$92,000 section 1411 NOL amount may be applied in determining A's net investment income in Year 3.

PFICs and CFCs

- Generally, subpart F inclusions from controlled foreign corporations (“CFCs”) and QEF inclusions from passive foreign investment companies (“PFICs”) that have made a QEF election are not considered to be dividends for U.S. federal income tax purposes, and section 1411 follows that treatment in applying NIIT.
- However, such inclusions are considered to be “other income” for purposes of section 1411 and thus if such other income is derived from a trade or business that is a passive activity or that is a trading business then such amounts will be taken into account in determining NIIT.

PFICs and CFCs (Cont')

- For other taxpayers (such as those invested in a partnership that is an investor), such inclusions will not be taken into account in calculating NIIT and will instead be included in the NIIT calculation only as such time as the earnings are distributed if such distribution is attributable to amounts that are or have been included in income for chapter 1 purposes under section 951(a) (subpart F inclusions) or section 1293(a) (QEF inclusions).
 - Such amounts will be dividends for section 1411 purposes even though they do not constitute dividends under chapter 1.
 - This requires complicated record keeping—essentially a taxpayer would have to track a different asset basis for chapter 1 and section 1411 purposes.
 - The regulations provide a coordination rule in the case that there is a trade or business in some years but not others during the holding period of the CFC or PFIC interest.

PFICs and CFCs (Cont')

- To eliminate the administrative burden this would require, a taxpayer may elect to include such amounts under section 1411 at the same time as for chapter 1.
 - This is known as a “g” election because the election is made pursuant to Reg. section 1.1411-10(g).
 - The election will apply to all interests in the CFC or PFIC with respect to which the election is made.
 - The election is irrevocable.
 - The election may be made by an individual, trust, estate, domestic partnership, S corporation or common trust fund that holds a CFC or PFIC interest directly or indirectly through one or more foreign entities.
 - The election may also be made by any of the foregoing entities if they hold an interest indirectly through a domestic partnership, S corporation, estate, trust or common fund that has not made the election.

Passive Activities

- A passive activity is described in section 1411 if:
 - Such activity is a trade or business; and
 - Such trade or business is a passive activity within the meaning of section 469 and the regulations thereunder.
- Generally, a trade or business activity is passive unless the taxpayer materially participates in the activity.

Passive Activities (Cont')

- Material Participation means:
 - You participate in the activity for more than 500 hours during the year;
 - Your participation in the activity constitutes substantially all of the participation by all individuals (including nonowners) in the activity of the year;
 - Your participation is more than 100 hours during the year, and no other individual (including nonowners) participates more hours than the taxpayer;
 - The activity is a significant participation activity in which you participate for more than 100 hours during the year and your annual participation in all significant participation activities is more than 500 hours. [A significant participation activity is generally a trade or business activity (other than a rental activity) that you participate in for more than 100 hours during the year but do not materially participate in (under any of the material participation tests other than this test)];
 - You materially participated in the activity for any five tax years (whether or not consecutive) during the 10 immediately preceding tax years;
 - For a personal service activity, you materially participated for any three tax years (whether or not consecutive) preceding the current tax year; or
 - A generic facts and circumstances test.

Passive Activities (Cont')

- Rental activity is generally per se passive regardless of whether it rises to the level of a trade or business and regardless of whether the taxpayer materially participates in the activity.
 - This is subject to an exception for real estate professionals.
 - A rental activity could be passive for purposes of section 469 but not for purposes of section 1411 if the rental activity does not rise to the level of a trade or business.

Passive Activities (Cont')

- Activities may be “grouped” together under section 469 in order to determine material participation.
 - This grouping will be respected for section 1411 purposes.
 - A taxpayer gets a “fresh start” to regroup in the first taxable year in which the taxpayer would be subject to NIIT.
 - A taxpayer may be able to regroup on an amended return if it meets certain conditions.

Passive Activities (Cont')

Any elections made to group activities under Section 469 are respected for purposes of determining if a trade or business is passive to a taxpayer.

A owns an interest in PRS, a partnership. PRS is engaged in two activities, X and Y. Both X and Y constitute trades or businesses, and they are not engaged in the trading of financial instruments.

Pursuant to Treas. Reg. section 1.469-4, A has elected to group X and Y. A participates in X for 620 hours and Y for only 50 hours during 2013.

Because the activities are grouped together, A materially participates in the combined activities and neither X nor Y is passive to A. Thus, income allocated to A by PRS is not included in net investment income .

Passive Activities (Cont')

It sounds like making sure a partnership or S corporation is non-passive is a no-brainer, but consider:

If an S corporation interest is non-passive, the flow-through income is not subject to SE tax under Rev. Rul. 59-221.

However, if an LLC interest is non-passive, the taxpayer may have traded 3.8% net investment income for 15.3% self-employment income under the Section 1402 regulations.

Passive Activities (Con't)

- Net rental income is generally subject to NIIT.
- However, it will not be if:

The taxpayer is a real estate professional under Section 469(c)(7), so that the income is not passive,

The rental activity rises to the level of a trade or business, and

The taxpayer materially participated in the activity

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DAVID & JOSEPH PL



Determination and reporting of net investment income for flow-through entities

Schedule K-1 Reporting

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				
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		



Schedule K-1 Reporting

17. Other information

A	Investment income	Form 4952, line 4a
B	Investment expenses	Form 4952, line 5
C	Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions
D	Basis of energy property	See the Shareholder's Instructions
E	Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
F	Recapture of low-income housing credit (other)	Form 8611, line 8
G	Recapture of investment credit	See Form 4255
H	Recapture of other credits	See the Shareholder's Instructions
I	Look-back interest—completed long-term contracts	See Form 8697
J	Look-back interest—income forecast method	See Form 8866
K	Dispositions of property with section 179 deductions	} See the Shareholder's Instructions
L	Recapture of section 179 deduction	
M	Section 453(l)(3) information	
N	Section 453A(c) information	
O	Section 1260(b) information	
P	Interest allocable to production expenditures	
Q	CCF nonqualified withdrawals	
R	Depletion information—oil and gas	
S	Amortization of reforestation costs	
T	Section 108(i) information	
U	Net investment income	
V	Other information	

Related Party Debt

- Interest income is always subject to the NIIT unless it is earned in the ordinary course of a trade or business (e.g., banks).
- **Example:**
 - John owns 100% of J&S, an S Corporation and is active in the business.
 - Rather than capitalize the company with equity, John capitalizes the company with \$10,000,000 of debt and charges a 4% interest rate.
 - J&S incurs \$400,000 of interest expense and Ryan earns \$400,000 of interest income resulting in no net change in John's taxable income.
 - For NIIT purposes, the \$400,000 of interest income is subject to the NIIT but the \$400,000 interest deduction is excluded because it is generated in a trade or business in which John is active.

Royalties

Royalties are subject to the NIIT unless they are earned in the ordinary course of a trade or business.

- Section 1411 does not define “ordinary course” but refers to case law and Reg. §1.469-2T(c)(3)(ii).
- Reg. §§ 1.469-2T(c)(3)(ii) and (iii) provide that royalties can only be derived in the ordinary course of a trade or business if the licensor:
 - created the property, or
 - performed substantial services or incurred substantial costs with respect to the development or marketing of the property

Royalties



Example:

- An S corporation acquires a patent to use in its manufacturing process but subsequently decides that it no longer needs the patent and sub-licenses it to a 3rd party.
- Is this royalty income subject to the NIIT if the owners are active in the business?

Schedule K-1 Reporting

- If the royalties are derived in the ordinary course of a trade or business, they are not subject to the NIIT and will need to be separately disclosed.
- If the royalties are not derived in the ordinary course of a trade or business, they are subject to the NIIT and will need to be separately disclosed.
 - Expenses allocable to a royalty subject to NIIT would need to be separately stated on the tax return
 - These expenses are often not separately reported if the owner is otherwise active.

Sale of Business Assets – Disposition of “Property”

- Net gain attributable to the disposition of property is subject to the NIIT.
 - If a flow-through entity disposes of property, it is not subject to the NIIT if the owner is active but is subject to the NIIT if the owner is passive.
- The proposed regulations do not define what types of property are included in this definition.
 - If gain or loss from a disposition is considered to be part of ordinary business income, it is included as Category 2 income.
 - If gain or loss from a disposition is considered to be a “disposition of property”, it is included as Category 3 income.
 - Category 3 income is limited to “net gains” so losses on this property cannot offset income in another category.

Sale of Business Assets – Disposition of “Property”

- Possible issues include dispositions of inventory, materials/supplies or accounts receivable factoring.
- Logic would suggest that gain or loss from this type of property is Category 2 income.
 - The preamble to the proposed regulations states that “if stock of an S corporation is sold and a section 338(h)(10) election is made, each shareholder's pro rata share of the deemed asset sale gain or loss may be taken into account in determining net investment income under section 1411(c)(1)(A)(iii)”.
 - This suggests that gain or loss from the sale of any asset is included in Category 3 and not Category 2.
 - Without clarification, losses on this type of property in ordinary business activities may be limited to “net gains” within Category 3.
- Schedule K-1 reporting for this would be complex



Sale of Depreciable Property

- When depreciable personal property is sold, gain is often included in 2 categories:
 - Gain up to the amount of depreciation claimed is recaptured as ordinary income under §1245.
 - Gain in excess of the depreciation claimed is potentially treated as capital gain under §1231.
- Schedule K-1 reporting
 - §1245 recapture is reported as a portion of ordinary income.
 - §1231 gain is reported on its own dedicated line.
- §1245 recapture should still be gain from the “disposition of property” and included in Category 3.
 - Separate K-1 disclosure may be required for this item.

Subpart F Inclusion

Subpart F inclusions generally do not constitute net investment income unless:

- Treated as dividends
- Attributable to a trade or business of the CFC that is a passive activity to the U.S. shareholder
- Trade or business of trading in financial instruments or commodities.

PFIC Inclusion

A U.S. person owning shares of a passive foreign investment company (PFIC Sec. 1297) is also required to include in taxable income currently his share of the PFIC's income (except QEF election).

There are complex rules that are applicable in Subpart F and PFIC circumstances made more complicated by the impact of new Section 1411.



Income from Foreign Corporations

- In general, income from a foreign corporation is included in the NIIT base only when cash is actually distributed, not when a deemed distribution is made under provisions such as Subpart F.
 - **Example:** Individual A owns all of the stock of foreign corporation F. F has a Subpart F income of \$100 in 2014.
 - F makes an actual distributions of \$100 in 2015.
 - In 2014, A has \$100 of deemed taxable income but \$0 subject to the NIIT
 - In 2015, A has \$0 of taxable income but \$100 subject to the NIIT



Income from Foreign Corporations

- Appropriate adjustments must be made to basis to not duplicate or eliminate income for NIIT purposes.
- Election is available to make the NIIT timing the same as for regular tax purposes but is made only by individuals (not by a flow-through entity).
- Flow-through entities must separately disclose enough information to allow the owner to properly calculate their NIIT.



Treatment of Business Sales



Sale of a Business - General

- An individual's gain or loss on the sale of a flow-through entity is subject to the NIIT since the property is not held in a trade or business.
 - Exceptions apply when an owner is active in a flow-through entity.
- The sale of the underlying assets of a flow-through entity follows general rules applicable to flow-through income.
 - If the owner is active, the flow-through activity is not subject to the NIIT.
 - If the owner is passive, the flow-through activity is subject to the NIIT.
 - Gain or loss on liquidation of an entity after it sells its assets is subject to the NIIT regardless of active or passive characterization of the owner.
- The sale of the stock of a C Corporation or a liquidating distribution from a C corporation is subject to the NIIT regardless of the owner's level of activity.



Sale of a Business - General

C corporation		
	Passive	Active
Sale of Assets*	Taxable	Taxable
Sale of Entity	Taxable	Taxable

Flow-through Entities		
	Passive	Active
Sale of Assets*	Taxable	Exempt
Sale of Entity	Taxable	Partial/full exclusion

* Gain or loss on liquidation of any business entity after it sells its assets is subject to the NIIT.



Active Owner's Sale of Flow-Through Entity

- An active owner adjusts the gain or loss from the sale of a flow-through entity so the sale is taxed similarly to what would have happened had the entity sold all of its assets and liquidated.
 - Creates parity between an entity sale and an asset sale.
 - Adopts a “deemed sale” model which is different than other deemed sale models that exist in the IRC.



Deemed Sale Model

- **Step 1:** The flow-through entity is deemed to sell all of its properties in a fully taxable transaction for cash equal to fair market value immediately before the actual disposition of the taxpayer's interest.
- **Step 2:** Gain or loss is calculated at the entity level on an asset-by-asset basis.
- **Step 3:** Gain or loss from each asset is separately allocated to the owners according to their ownership percentage.



Deemed Sale Model

- **Step 4:** Gains and losses from assets used in an active, non-financial instrument trading business are aggregated and:
 - Net gain will decrease, but not below zero, the transferor's net gain on the sale of the business interest.
 - Net loss will increase, but not above zero, the transferor's net loss on the sale of the business interest.



Deemed Sale Model – Example 1

- S corporation (S) is engaged in a single trade or business.
- Mary is active in the trade/business of S.
- John is passive in the trade/business of S.
- Mary and John sell 100% of the stock of S to a third party for \$120,000 (the fair market value of the assets of S).
- Mary recognizes \$15,000 gain on the stock sale (\$90,000 received - \$75,000 stock basis).
- John recognizes \$5,000 gain on the stock sale (\$30,000 received - \$25,000 stock basis).
- John is not eligible to adjust his net gain on the stock disposition because the trade/business of S was passive to him.
- Mary is eligible to adjust her net gain because the trade/business of S was not passive with respect to her.



Deemed Sale Model – Example 1 (continued)

- **Step 1:** On a hypothetical sale of assets, S will receive cash equal to the fair market value of each asset.
- **Step 2:** Gain/loss is calculated asset-by-asset.
- **Step 3:** Mary is allocated 75% of the gain/loss from each asset.
- **Step 4:** Mary has been allocated \$15,000 of gain from the deemed sale of active, business assets.
- **Result:** Mary recognizes no net investment income on this sale of S corporation stock.
- Stock sale gain of \$15,000 less adjustment from deemed sale of \$15,000.



Deemed Sale Model – Example 2

- Same facts as Example 1 except Mary has an outside basis of \$70,000.
- John is still not eligible to adjust his net gain on the stock disposition because the trade/business of S is passive with respect to him.
- Mary is eligible to adjust her net gain because the trade/business of S is not passive with respect to her.
- Mary recognizes \$20,000 of gain on sale of the sale of her S stock.
- \$15,000 negative adjustment to net gain due to the deemed sale of active, business assets of S.
- **Result:** Mary recognizes \$5,000 of net gain as subject to the NIIT.



Deemed Sales Statement

- Any transferor making an adjustment under the deemed sale rules must attach a statement to the transferor's return for the year of disposition which must include:
 - A description of the disposed interest;
 - The name and taxpayer identification number of the entity disposed of;
 - The FMV of each property of the entity;
 - The entity's adjusted basis in each property;



Deemed Sales Statement

- The transferor's allocable share of gain or loss with respect to each property of the entity;
- Information regarding whether the property was held in a trade or business not described in §1411(c)(2);
- The amount of the §1411(c)(1)(A)(iii) gain on the disposition of the interest; and
- The computation of the adjustment under the Proposed Reg. §1.1411-7(c)(5).



Business Sale and Deemed Sale Model Issues and Planning

- Deemed asset sale statement
- Deemed asset sale calculation
 - Determination of FMV of each asset
 - Partnership allocations
 - Determination of trade or business character of each asset
 - Cost of compliance
 - Applicability to any sale of any size
 - Owner's access to or availability of information
- Impact of liabilities on deemed sale model



Business Sale and Deemed Sale Model Issues and Planning

- **Qualified Subchapter S Trust (QSST)**
 - Generally, S corporation stock held by a QSST is treated as being held in a grantor trust for the income beneficiary and any income is taxed directly to the income beneficiary.
 - If the QSST sells its stock, the consequences of the sale are reported at the trust level, not by the income beneficiary.
 - Proposed regulations do not address coordination of QSST and NIIT rules but additional rules are anticipated in final regulations.



Business Sale and Deemed Sale Model Issues and Planning

- **Goodwill and property held in multiple trades or businesses.**
 - Gain from property must be allocated among the trades or businesses on a basis that reasonably reflects the use of the property.
 - The gain on goodwill is allocated to the different businesses on the basis of the fair market value of assets held by each business.
 - May not be relevant if active or passive in all trades or businesses being sold or retained.



Business Sale and Deemed Sale Model Issues and Planning

- **Installment sales**
 - Dispositions occurring after 12/31/13.
 - Installment sales of entities that occur after 12/31/13 will be subject to the net adjustment calculation.
 - Net gain will be determined in the year of disposition and any gain subject to the NIIT will be taken into account proportionally under installment sale rules.



Business Sale and Deemed Sale Model Issues and Planning

- **Dispositions occurring prior to 1/1/14.**
 - Net adjustment rules do not apply and deferred gain is fully subject to NIIT.
 - Irrevocable election available to make net adjustment rules applicable.
- **Passive or active**
 - Application of NIIT to year of an entity sale is based on the passive or active characterization only in the year of sale.

Conclusion

The impact of the new 3.8% surtax on net investment income will be a surprise to most taxpayers and their professional tax return preparers.

Whether the benefit intended by imposing this tax will be worth the costs remains an open question.