Final regulations on Net Investment Income Tax: a clearer picture emerges

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In brief

The Patient Protection and Affordable Care Act and The Health Care and Education Reconciliation Act of 2010 created a new tax regime effective for 2013—the 3.8% Net Investment Income Tax (NIIT). The legislation provided the framework for the new tax. The IRS had to fill in the details.

The IRS released draft income tax Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts) in August 2013. Then in late November 2013 the IRS issued final regulations on the NIIT as well as new proposed regulations on certain aspects of the NIIT.

The 200+ pages of final NIIT regulations and newly issued 2013 proposed regulations (including preamble and Q&A section) provide a reasonably clear picture of how to calculate the new NIIT. However, a few areas requiring interpretation still remain. Our Personal Financial Services Tax Insight, Understanding the Net Investment Income Tax, also known as the Medicare Contribution Tax, dated February 22, 2013, provides a detailed discussion of the tax calculation.

In detail

Overview

The NIIT applies to 'net investment income,' which is gross investment income less specified deductions. The legislation and regulations divide 'investment income" into three categories (discussed below). Many of the questions raised by the proposed regulations concerned the classification of income among the three categories as well as speculation about types of income that would not be subject to the NIIT. The IRS also received multiple comments about the deduction portion of the calculation and made a number of changes to those provisions.

The proposed regulations were not perfectly coordinated with the preamble and Q&A. Some items discussed in the preamble or Q&A were not mentioned in the proposed regulations themselves. The proposed regulations were also forced to deal with areas where the US Federal income tax ('income tax') rules are not especially clear. The preamble to the final regulations notes that the coordination issues have been corrected and those uncertain income tax areas are outside the scope of the NIIT regulations.

Because the new NIIT is effective in 2013, taxpayers have had to make estimated tax payments with this additional tax in mind. The IRS received multiple comments about modifying this requirement or providing exceptions. The IRS declined to provide special NIIT exceptions to the estimated tax requirements for 2013.

The IRS also was asked to comment on the interaction between NIIT and the self-employment tax as applied to income from limited liability companies and limited liability partnerships. The IRS declined to comment on this, noting that application of the self-employment tax to LLCs and LLPs was outside the scope of the NIIT regulations.

Categories of income

The three categories of income under the NIIT are portfolio type income, trade or business type income, and gains from the disposition of property. The preamble to the final regulations discusses a significant number of comments about the three categories of income. Unlike the proposed regulations, the preamble and final regulations allow losses in one category to offset income in another category through new 'permitted deductions.'

Portfolio income (category one)

This category includes interest, dividends, annuities, royalties, and certain types of rental income. Special rules apply to passive foreign investment company (PFIC) income and income from a controlled foreign corporation (CFC). The final regulations note that dividends paid on employer securities held in an employee stock option plan (ESOP) are specifically exempt from NIIT.

After IRS officials made various comments about different types of income at public events, the IRS was specifically asked to provide a listing of income not subject to NIIT. Items such as lottery and gambling winnings, executor fees, Social Security benefits, alimony, and foreign currency gains from personal transactions were all mentioned as possible exclusions. Alimony and Social Security benefits are specifically mentioned in the IRS Q&A materials as not subject to NIIT.

The IRS declined to provide a list of excluded income but the final regulations and preamble did comment on certain annuity items. For example, ***foreign pension/retirement income*** that is received as an annuity for past services will not be considered 'annuity' income and is excluded from NIIT (as is income from traditional US retirement sources like IRAs and qualified plans). The final regulations note that income from ***charitable gift annuities*** is subject to NIIT. The final regulations also confirmed that while annuity income is part of the portfolio category, income from the disposition of an annuity would be treated as gain on disposition if the annuity were sold for an amount greater than its cash surrender value.

As expected, ***rental income*** was the subject of a significant number of comments, because the legislation specifically includes rental income in the portfolio category even though many types of rental income represent a trade or business activity (a different NIIT income category). One particular point of concern was the proposed regulation characterization of a single rental property as portfolio income in all situations. Commenters pointed out that a single rental property has been treated as a trade or business in various court cases. In response, the IRS modified the final regulations as well as the example to remove the single property reference. Nonetheless, the preamble to and the final regulations themselves continue to maintain the distinction between portfolio type rental income (as specified in the statute) and trade or business type rental income. This is likely to be an area of controversy for some time.

The IRS also was specifically asked about application of the passive activity income recharacterization rules when an operating business rents property from a related entity. The passive activity rules recharacterize the income as non-passive. The IRS accepted the suggestion that a special ***self-charged rent exclusion*** be created. Under this exclusion, rental income received from an active trade or business will not be subject to NIIT when received from a related active business.

The IRS received many comments about the special NIIT rules that apply to PFIC and CFC income. In particular, clarification was requested about the need to make a ***special QEF election for NIIT purposes*** and whether the first owner of the PFIC/CFC could make the election. The final regulations point out that the special NIIT QEF election is made on an entity-by-entity basis (similar to a traditional QEF election) on Form 8960, although draft Form 8960 contains no such election section.

The final regulations also permit partnerships and S corporations to make the NIIT QEF election with the consent of shareholders or partners. The ability to make the NIIT QEF election at the partnership/corporation level is designed to simplify compliance.

Trade or business income (category two)

The second category of income includes trade or business income from 'passive activities' and income from the business of trading in financial instruments or commodities. The determination of whether a business activity is 'passive' or 'active' (more correctly referred to as 'material participation') requires a journey through the complex passive activity loss rules and regulations. Those regulations require taxpayers to group 'undertakings' into activities based on a series of guidelines designed to capture the economic unit. Each 'grouped' activity then is tested for material participation.

The IRS identified ***activity grouping*** as an area where taxpayers might have been insufficiently diligent in prior years. The final regulations, like the proposed regulations, permit taxpayers to reconsider activity groupings and 'correct' them for the first year they are subject to NIIT (sometimes referred to as a 'fresh start' by commenters). Lower income taxpayers who are not subject to NIIT are not given the opportunity to regroup.

The final regulations expand on the 'first year they are subject to NIIT' concept and extend it to amended and audited returns. The final regulations provide that a taxpayer initially subject to NIIT can regroup undertakings and activities but loses the ability to regroup if the taxpayer is no longer subject to NIIT as the result of an amended return or changes on audit. Likewise, if a taxpayer is subject to NIIT as a result of an amended or audited return change, the taxpayer will be allowed to regroup (with a statement attached to the return). Finally, the final regulations retain the notice requirement, so taxpayers making a 'grouping' change must attach a notice of explanation to the return.

A number of partnership and S corporation commenters asked whether the regrouping election available to individuals could be extended to pass-through entities. The IRS declined to **allow *regrouping by partnerships or S corporations***. What is not addressed in the final regulations is the de facto ability of an individual to group activities if the partnership or S corporation had provided activity-by-activity detail in prior years. In other words, entity regrouping by a partnership would be unnecessary if activity-by-activity detail is provided on each partner's annual tax information.

The IRS also received extensive commentary about ***traders in financial instruments*** and the practical difficulties associated with reporting trading income and expenses—significant amounts of trading income might be reported as dividends and interest (the portfolio category) while other income would be reported as transactional gains (the gains from disposition of property category) and some expenses could be used to offset self-employment income (not subject to NIIT). The IRS recognized that trader activity income and expense items will straddle categories and the final regulations provide greater guidance. However, this still is an area where taxpayers and tax preparers will need to make difficult judgments when determining what information to include on tax forms. Tax reporting by traders in financial instruments will be more complex than ever.

Another area of great concern is the interaction of the NIIT rules with passive activity loss rules for trusts and estates. The IRS received a number of comments about this topic. Many of the comments related to the basic lack of guidance in the passive activity rules in general and the conflict between a single court case and several IRS private letter rulings. The preamble to the final regulations acknowledges the lack of guidance for trustees but provide no further assistance. This means that ***trust owners of business activities*** are left to make their own decisions about an important tax determination using the available, but conflicting, guidance. Our PCS Tax Insight, New Medicare tax creates trustee dilemma, dated June 24, 2013, discusses this topic in detail.

Real estate professionals are the subject of a long discussion in the preamble to the final regulations. The issue with ***real estate professionals*** is whether the 'real estate professional' designation covers all rental activities reported on the return or whether each activity must be examined separately, as is the case for income tax purposes. The IRS has carved out a NIIT exclusion for real estate professionals with a similar activity-by-activity determination (being classified as a real estate professional does not automatically exempt all of one's rental income from NIIT). The NIIT real estate professional determination is based on a 500 hours of participation requirement in addition to the 750 hour requirement to be classified as a real estate professional.

The NIIT treatment of certain types of ***partnership payments*** (e.g. guaranteed payments) was not specifically addressed in the original proposed regulations. The new 2013 proposed regulations recognize that not all partnership payments are based on current income and specifically address allocations of income for services, for use of capital, or for a share of a retiring partner's interest in the partnership. As expected, payments made for past services would be exempt from NIIT even if they were not currently subject to self-employment tax. Payments made for the use of capital are treated as either category one (portfolio income) or category three income (gain/loss from disposition of property) depending on how calculated. The partnership must now provide sufficient information about the nature of partnership payments made during the year for the partner to properly classify the payment for NIIT purposes.

Gains from disposition of property (category three)

The final category of income subject to NIIT is gain from the disposition of property (other than property held in an active trade or business), which includes gain on the sale of stocks, bonds, mutual funds, and real estate as common examples. The sale of rental property is subject to NIIT unless the rental activity is part of an active trade or business.

The IRS received a significant number of comments regarding capital loss carryovers as well as the disposition of passive (and formerly passive) activities. As a result, the final regulations permit ***prior-year capital loss carryovers*** to offset current year gains. Further, the final regulations provide that the income tax $3,000 capital loss offset of ordinary income is a 'permitted deduction' for NIIT purposes against other categories of net investment income.

Commenters also requested clarification with respect to the distribution of appreciated employer securities from qualified plans. Special income tax rules apply to the 'net unrealized appreciation' on this stock (the difference between the plan's cost for the securities and the value at distribution is not taxed until the stock is sold). The final NIIT regulations provide that this ***'net unrealized appreciation on employer securities'*** is exempt from NIIT. However, any gain realized after the date of distribution is subject to NIIT when the stock is sold.

The ***disposition of a passive activity*** and how to account for previously suspended passive losses also was also a topic of much interest among commenters. The mechanical details of how the released suspended passive losses are 'categorized' between the three categories of income could produce varying NIIT results. The final regulations conclude that the "losses are taken into account for net investment income purposes in the same manner" as for income tax purposes.

The passive activity discussion in the preamble ends with the comment that "the losses may constitute properly allocable deductions … depending on the underlying character and origin of the loss.' No examples are provided. The end result is that taxpayers who dispose of passive activities will need to carefully follow the income tax impact of each loss and then mirror that treatment for NIIT purposes. It appears that losses not used against gains or trade/business income becomes current year 'permitted deductions' that may offset other categories of income.

Responding to a large number of comments, the IRS removed the proposed regulations dealing with the ***sale of a partnership or S corporation*** from the final regulations and released a separate set of 2013 proposed regulations with a request for additional comments. Gain from the disposition of an interest in a partnership or S corporation presents a particular problem because the NIIT does not apply to gains on property associated with a material participation trade or business. The new 2013 proposed regulations attempt to balance the need to distinguish between excluded trade or business gains and portfolio gains subject to NIIT without creating a compliance problem. The new 2013 proposed regulations compute gain or loss on an activity by activity basis rather than asset by asset. They also include a simplified optional reporting method for sales of small businesses (gain less than $250,000).

Finally, clarification was requested as to how ***gains triggered as a result of expatriation*** would be treated for NIIT purpose. The final regulations confirm that such gains are subject to NIIT at departure.

Deductions from investment income

The proposed regulations contained a limited list of deductions that could be used to offset investment income. The final regulations are more precise in calculating the deductions and also expand the original list to include several new items. The expanded list is as follows *(new items are in italics)*:

- investment interest expense
- investment expenses
- expenses attributable to rents and royalties
- penalties for early withdrawal of savings
- allocable state and local income taxes
- foreign taxes (but only if decision to deduct all foreign taxes has been made)
- tax preparation and planning fees
- capital losses in excess of capital gains (limited to $3,000)
- released suspended losses from passive and former passive activities (to the extent not used to offset gains or current year income)
- unrecovered basis in an annuity
- losses on termination of an estate/trust
- certain expenses of trusts and estates (fiduciary fees, attorney fees, etc.)
- bond premium amortization (normally an adjustment to income)
- estate tax deduction for income in respect of a decedent (IRD) items
- contingent payment debt instrument adjustments

- self-charged interest rule for non-passive activities
- net operating losses (NOLs) as recalculated for NIIT purposes.

The final regulations not only add additional 'permitted deductions,' they also expand on many of the deductions and how to calculate the limitations. In particular, the final regulations discuss the mechanical details associated with the itemized deduction phase-out (Pease limit) and the 2% floor on miscellaneous deductions.

Multiple commenters pointed out that two limitations apply to ***investment related deductions***. First is the 2% threshold that applies to all miscellaneous deductions, not just investment related deductions. Second is the effect of the Pease limit on itemized deductions in general. The proposed regulations required that the 2% and Pease limitations be applied pro-rata to all deductions. The result would apply two reductions to each investment related deduction. The final regulations abandon this approach in providing that the NIIT deduction is the lesser of: 1) gross investment related deduction or 2) the amount of all deductions allowed after the limitation. The effect of this new approach is that investment related deductions will be subject to less reduction for NIIT purposes.

Commenters made multiple suggestions on the ***method to allocate state and local income taxes*** to investment income. In particular, the distinction between the state and local tax deduction reported on the income tax return (which will often include taxes paid for prior years) and the actual state liability for the current year (as reported on the state returns) was noted. Neither the proposed or final regulations specify a particular method but contain an example using the current year tax deduction as a starting point. The preamble to the final regulations notes that many methods are possible but declined to specify a method or even provide additional examples.

The IRS did point out that some allocation methods may produce a current-year NIIT deduction for state and local taxes that may be refunded in a subsequent year. The subsequent refund of a previously deducted amount would then be subject to NIIT when received based on the tax benefit rule. The preamble to the final regulations specifically points out the interaction of state and local tax deductions for income and AMT purposes does not apply to NIIT, and that a separate NIIT deduction benefit would have to be calculated. Taxpayers and tax return preparers may want to consider the application of the tax benefit rule and the need to deal with refunds in later years when determining the 'allocable state and local tax deduction' for NIIT purposes.

The final regulations expanded the permitted deductions for ***expenses associated with trusts and estates*** to include such things as fiduciary fees, attorney fees, accounting fees, and administration expenses. Likewise, final-year deductions from an estate or trust are permitted deductions.

Although the proposed regulations specifically excluded NOLs from the calculation of net investment income, the final regulations now permit specially calculated ***NIIT NOLs.*** The final regulations contain an extensive discussion of how to calculate NIIT NOLs and the need to track them separately.

Credits

Neither the legislation nor the proposed regulations discussed credits against NIIT. The final regulations provide that no credits can offset the tax including foreign tax credits. The preamble to the final regulations also addresses the impact of income tax treaties and concludes that the NIIT is not an income tax. The preamble further concludes that the double tax provisions in most model income tax treaties would not permit a credit against NIIT. The IRS position is clear on this point although there continues to be disagreement among some professional groups.

Individuals and trusts: special rules

Only individuals, trusts, and estates are subject to NIIT. The final regulations address more special individual and trust situations than did the proposed regulations.

Individuals

The NIIT applies to US citizens and residents but does not apply to nonresident aliens. Commenters requested additional guidance on circumstances involving dual-resident and dual-status individuals, as well as those involving nonresident aliens married to US citizens.

The final regulations provide that a *dual resident* treated as a nonresident as a result of a treaty will be treated as a nonresident for NIIT purposes. *Dual-status individuals*—individuals that are part-year residents of the US and part-year residents of another country—will be subject to NIIT only for the portion of the year that they are US residents. The threshold amount is not pro-rated or reduced for dual-status residents.

Commenters requested that a dual-status individual who is a non-resident alien at the beginning of the year and a resident of the US at the close of the year who is married to a US citizen be given an NIIT election similar to the election available for income tax purposes. The IRS complied with this request. The election allows the *dual-status* individual to be treated as a full-year resident for both income tax and NIIT purposes. If the election is not in place, the married couple will be required to file as married filing separate returns (each spouse calculates NIIT separately with the $125,000 threshold).

Trusts and estates

The taxation of trusts depends on the type of trust and whether the trust income is distributed or retained by the trust. To the extent the trust or estate retains income, it will be subject to NIIT at the trust level. Income distributed to beneficiaries may be subject to NIIT at the beneficiary level. Similar rules apply to estates. The final regulations expand the 'permitted deductions' allowed to a trust or estate but do not help with the passive activity determination (see prior discussion).

An ***Electing Small Business Trust*** *(ESBT)* is a trust that owns shares in an S corporation. Special rules apply to calculate income tax associated with S corporation income. In effect the trust is bifurcated into 'portions' for income tax purposes — the S portion and the regular portion. Different tax calculation methods apply to each portion. The proposed NIIT regulations required that the two portions be aggregated in determining the threshold for NIIT purposes but that NIIT be separately calculated for each portion. The final regulations acknowledge a number of comments that suggested the 'portions' be combined for NIIT completely or kept apart for purposes of the threshold. The final regulations require taxpayers to combine the 'portions' to determine whether the NIIT threshold has been reached but continue to separate the 'portions' for actual tax calculations.

A ***charitable remainder trust*** pays income to a beneficiary for a period of time, after which the assets are transferred to charity. The trust itself pays no income tax. Annual distributions to a beneficiary come from a precise ordering of income received by the trust. The proposed regulations created a new category of income rather than bifurcate existing categories of income (an attempt to simplify recordkeeping). The final regulations abandon the separate category of post-2012 investment income and instead adopt the recommendation of commenters that each existing category of income be bifurcated into pre- and post-NIIT income.

Foreign trusts and estates

The final regulations specifically provide that ***foreign estates*** with little or no connection to the US are not subject to NIIT. However, US beneficiaries of foreign estates will be subject to NIIT on distributions of income from the foreign estate.

Likewise, the final regulations provide that ***foreign trusts*** are not subject to NIIT. The final regulations do not directly address whether US beneficiaries will be subject to NIIT on distributions of current-year income (presumably they are). However, the preamble to the final regulations specifically mentions that distributions of accumulated income are not subject to NIIT currently, but that the IRS will continue to consider how NIIT should be applied to accumulation distributions.

The takeaway

The NIIT is a complex stand-alone tax. The legislation did not provide definitions or terminology, and the proposed regulations left many questions unanswered. The final regulations address many of those questions. However, the complexity of the calculations and the need to make subtle distinctions for record-keeping and compliance will likely continue to present a challenge to taxpayers, tax practitioners, and the IRS.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

Personal Financial Services

Brittney Saks, *Chicago*
(312) 298-2450
brittney.b.saks@us.pwc.com

Sheryl Eighner, *Chicago*
(312) 298-2481
sheryl.eighner@us.pwc.com

Jim Medeiros, *Boston*
(617) 530-7353
james.m.medeiros@us.pwc.com

Chris Essig, *Cleveland*
(216) 875-3099
christopher.m.essig@us.pwc.com

Rich Wagman, *Boston*
(617) 530-7003
richard.s.wagman@us.pwc.com

Mark Nash, *Dallas*
(214) 999-1424
mark.t.nash@us.pwc.com

Kent Allison, *Florham Park*
(973) 236-5253
kent.allison@us.pwc.com

Becky Weaver, *Kansas City*
(816) 218-1729
becky.weaver@us.pwc.com

Michael Spielman, *New York*
(202) 312-7905
michael.spielman@us.pwc.com

Alfred Peguero, *San Francisco*
(415) 498-6111
alfred.peguero@us.pwc.com

Jeff Saccacio, *Southern California*
(213) 217-3227
jeff.j.saccacio@us.pwc.com

Bill Zatorski, *Florham Park*
(973) 236-4943
william.zatorski@us.pwc.com

Allison Shipley, *Miami*
(305) 375-6303
allison.p.shipley@us.pwc.com

Karl Weger, *Philadelphia*
(267) 330-2496
karl.weger@us.pwc.com

Scott Torgan, *San Francisco*
(415) 498-6240
scott.a.torgan@us.pwc.com

Ryan Lauridsen, *Washington, DC*
(703) 918-4251
ryan.lauridsen@us.pwc.com

Bill Fleming, *Hartford*
(860) 241-7044
william.r.fleming@us.pwc.com

Evelyn Capassakis, *New York*
(646) 471-2363
evelyn.capassakis@us.pwc.com

Al Vernacchio, *Pittsburgh*
(412) 355-6028
albert.j.vernacchio@us.pwc.com

Roxanne Laine, *San Jose*
(408) 817-5956
roxanne.laine@us.pwc.com

Gregg Muresan, Cleveland
(216) 875-3504
gregg.g.muresan@us.pwc.com