

WNTS Insight

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Proposed regulations clarify scope and application of new net investment income tax

In brief

The IRS on November 30 issued proposed regulations concerning the net investment income tax under new section 1411 of the Internal Revenue Code, which was enacted as part of the Health Care and Education Reconciliation Act of 2010. The new tax will be imposed, at a 3.8% rate, on certain net investment income of individuals, estates, and trusts that have income above the statutory threshold amounts.

For individuals, the thresholds are \$200,000 for single taxpayers, \$125,000 for married taxpayers filing separately, and \$250,000 for married taxpayers filing jointly. Estates and trusts will be subject to the tax if they have undistributed net investment income and also have adjusted gross income (AGI) over the dollar amount at the highest tax bracket for an estate or trust.

With the new tax effective for tax years beginning after December 31, 2012, many taxpayers having been awaiting the guidance provided in the proposed regulations to clarify the scope and application of the new tax.

While the Obama Administration and Congressional leaders negotiate over "fiscal cliff" issues, including expiring 2001 and 2003 individual tax rates, President Obama and Senate Democrats are not expected to accept any proposals during the lame-duck session to delay implementation of the 2010 health care law. As a result, taxpayers can anticipate that the net investment income tax provisions of the health care law will be implemented as scheduled.

The IRS has requested public comments on the proposed regulations by March 5, 2013. A public hearing is scheduled for April 2, 2013.



Actions to think about

With the end of the year just a few weeks away, understanding the tax and the proposed regulations will be valuable as taxpayers complete their year-end tax planning. In 2013, the new net investment income tax will be imposed in addition to a potential increase in the current tax rates on capital gain and qualified dividend income. The Obama Administration has proposed to increase the top capital gains tax rate to 20 percent and to tax dividends as ordinary income.

The 3.8 % net investment income tax may be a factor in whether to accelerate income the end of this year. Also, some companies may consider paying special year-end dividends, and may re-evaluate stock buyback programs if rates for dividends and capital gains change.

Proposed regulations

The proposed regulations, which run 159 pages, provide significant insight to how the new tax will be applied.

Scope of tax

For individuals, the tax is imposed on the lesser of (1) net investment income or (2) modified AGI over a threshold amount (\$250,000 for a married couple filing a joint return, \$125,000 for a married individual filing a separate return, and \$200,000 for all other individuals). Modified AGI is defined as AGI plus any foreign income excluded under section 911.

The tax does not apply to nonresident aliens, tax-exempt trusts, and certain charitable remainder trusts.

For an estate or trust, the tax is imposed on the lesser of (1) undistributed net investment income or (2) the excess of AGI over the dollar amount at which the highest income tax bracket applicable to the estate or trust begins.

The tax is subject to the individual estimated tax provisions and is not deductible in computing individual income tax. The net investment income tax is a payroll tax that is in addition to and calculated separately from all other taxes. Thus, for example, the amount of tax will be added onto, rather than factored into, the calculation of regular income tax or alternative minimum tax.

Tax base

Section 1411 defines net investment income as investment income less any deductions properly allocated to such income. Investment income includes gross income from interest, dividends, annuities, rents, and royalties (other than income derived from an active trade or business), as well as net capital gain. Income from working capital also will be subject to the new tax, as will any income from limited partnerships or from other pass-through entities in which a taxpayer does not materially participate (as determined under section 469).

Section 1411 also provides that with respect to a disposition of a partnership interest or S corporation stock, net investment income includes only the net gain attributable to property held by the entity that is not properly attributable to an active trade or business.

Interest income on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence are not considered investment income for purposes of the tax. Further, investment income does not include distributions from a qualified retirement plan or amounts subject to self-employment taxes.

The proposed regulations also provide a regrouping "fresh start" under section 469 for certain taxpayers.

Other guidance

In addition to discussing many of the items mentioned above, the proposed regulations also address:

- Trades and businesses to which the new tax applies; and
- Treatment of controlled foreign corporations and passive foreign investment companies.

Due to the significance of the proposed regulations and their impact on many different types of taxpayers, a forthcoming WNTS Insight will provide detailed analysis of the proposed regulations.

The proposed regulations may be found [here](#).

IRS FAQs on the new tax may be found [here](#).

Let's talk

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