
United States: Net investment income tax may result in double taxation and more complexity

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In brief

The Internal Revenue Service (IRS) recently released [final regulations](#) regarding the application of the Net Investment Income Tax (NIIT) as well as final [Form 8960, Net Investment Income Tax – Individuals, Estates, and Trusts](#) and corresponding [instructions](#). The NIIT affects tax years that begin on or after January 1, 2013 and applies to US citizen and resident individuals with higher incomes on passive-type income (such as interest, dividends, and capital gains.) The final regulations address many questions that were previously unclear with respect to how the NIIT applies in a cross-border context (see prior [Global Watch](#)).

A critical issue is whether the NIIT may be offset by foreign tax credits for US federal income tax purposes. This question has been resolved under the final regulations in an unfavorable manner for US taxpayers – no foreign tax credit may be claimed to reduce the NIIT imposed under Section 1411 of the Internal Revenue Code (Code). Though the final regulations did not directly rule out the possibility of a foreign tax credit being possibly available under the terms of an income tax treaty, comments in the preamble to the final regulations indicate that both the Treasury Department and the IRS do not believe that such a credit should generally be permitted.

As a result, many high earning US taxpayers with net investment income that is subject to both the NIIT and foreign income tax may be faced with double income taxation. Should this happen, companies that tax equalize international assignees on ‘personal’ income may suffer increased assignment costs and those that don’t may have employees questioning why their personal tax costs have increased.

This Tax Insight highlights several important questions with respect to how the NIIT applies in a cross-border context and how they are resolved under final guidance. Mobility professionals should determine how these issues may impact assignment tax reimbursement costs, policies and procedures, and communication plans. For example, do policies provide that the company bear the cost of *any* US tax on an assignee’s overall taxable income? In addition, what procedures are in place to allow the assignee to increase his/her withholding to cover this additional tax?

In detail

Background

The NIIT (also known as the Unearned Income Medicare Contribution) was enacted under the Patient Protection and Affordable Care Act of 2010 (PPACA) and went into effect on January 1, 2013. It applies to individuals, estates, or trusts that have modified adjusted gross income (MAGI) above defined statutory thresholds. See previous [Global Watch](#) for more details, including a description of what type of income constitutes net investment income and may therefore be subject to the NIIT. See also comments that PwC submitted to the IRS on August 1, 2013 in response to proposed guidance ([click here](#) to view) in which the final regulations address.

Cross-border issues addressed under the final regulations

1. Can the NIIT be reduced by foreign tax credits to prevent double taxation?

Unfortunately the Treasury Department and the IRS believes the answer to this significant issue is 'no'. The final regulations reiterate the rule that foreign tax credits are only allowed against taxes imposed by Chapter 1 of the Code. Because the NIIT is included under Chapter 2A, foreign taxes allowed as a foreign tax credit under the Code are not allowed as a credit against the NIIT.

The preamble to the final regulations discusses in very general terms,

whether credit relief may be afforded under an income tax treaty. The IRS states that the final regulations are not an appropriate vehicle for guidance on this issue as it relates to a specific treaty. However, the IRS further states that treaties containing language similar to that in Article 23(2) of the US Model Income Tax Convention, which refers to limitations of US law, would not provide an independent basis for a credit against the NIIT. As a result, it appears unlikely that the IRS will allow a foreign tax credit even if a treaty applies.

A deduction for foreign taxes will be available against income subject to the NIIT, but only if the individual has claimed a deduction (not a credit) against income subject to the regular income tax. The deduction for foreign taxes is usually less beneficial to the taxpayer since it reduces taxable income rather than being a dollar for dollar offset to the tax.

Observation: *The practical result is that persons with net investment income that is subject to foreign income tax are expected to face double taxation, i.e., subject to both foreign taxes and the NIIT. This may be mitigated for NIIT imposed on US source investment income if the foreign country considers the NIIT a creditable tax, but is not likely to be mitigated when imposed on foreign source investment income (regardless of whether the country of residence considers the NIIT a creditable tax). The*

deduction of foreign taxes for US tax purposes could help to mitigate a double tax situation, but this may be less favorable to the taxpayer on an overall basis.

2. Are retirement plan and social security distributions included in net investment income?

Net investment income does not include any distribution from a US qualified plan or arrangement and the proposed regulations provided rules relating to whether an amount was a distribution within the meaning of this rule. However, it wasn't clear whether distributions from employer-sponsored or similar foreign retirement plans that are not qualified under US rules would be considered net investment income. PwC requested that the exemption for US qualified plans be expanded to include all of these situations. However, the IRS did not adopt this suggestion in the final regulations.

Notwithstanding, the final regulations may provide an argument that certain foreign pension distributions should be exempt from the NIIT if such benefit could be viewed as an annuity in consideration for services rendered. Income from an annuity is generally subject to NIIT, however, for NIIT purposes, the final regulations state that gross income from annuities does not include amounts paid in consideration for services rendered.

Observation: *The practical result is that distributions from employer-sponsored and similar foreign retirement plans will need to be further analyzed to determine their treatment for NIIT purposes. In many instances, taxable distributions from foreign retirement plans are considered deferred compensation for services rendered for US tax purposes and therefore not subject to NIIT. Practitioners should be aware that this issue may be complex depending upon the situation.*

In addition, it was unclear whether social security benefits were included in net investment income and therefore subject to NIIT. The final regulations clarify that net investment income does not include social security benefits.

Observation: *The US social security system is separate and apart from the application of the NIIT. While persons with social security obligations enjoy totalization agreements to potentially minimize social security liability, such agreements do not cover the NIIT. Therefore, assignees would not be able to avoid the NIIT through the use of these agreements.*

3. Are part-year residents and dual-resident individuals subject to the NIIT?

Previous IRS guidance was unclear as to how the NIIT applied to foreign individuals working temporarily in the US who are only residents for part of the year and are non-resident aliens for the other part of the year (e.g., a 'dual status' tax year). Final regulations clarify that dual-status residents should be subject to the NIIT only with respect to the portion of the year during which such individuals are US residents. As a result, only income he/she receives

during the portion of the year for which he or she is treated as a US resident is potentially subject to the NIIT.

Moreover, it was also unclear how the threshold amounts with respect to the NIIT apply to those who may be non-resident aliens for part of the tax year. Under the final regulations, the statutory threshold amounts to be reached before application of the NIIT are not reduced or otherwise prorated for dual-status residents.

Observation: *Both of these clarifications should be welcome news to dual-status residents, particularly that an individual must still reach the higher income thresholds for the NIIT to apply. Note, however, that the IRS specifically stated that they may reconsider the treatment of dual-status residents if taxpayers are applying these rules inappropriately.*

In addition, proposed guidance was unclear how the NIIT applied to dual-resident individuals (i.e., those resident of the US and a foreign country at the same time) who utilize so-called treaty-tie breaker provisions of an income tax treaty between the United States and a foreign country. Under these provisions, a dual-resident may determine they are resident of a foreign country rather than the US for tax purposes. The final regulations provide that such dual-residents should be treated as non-resident aliens for NIIT purposes (similar to their treatment for regular US federal income tax purposes) and therefore not subject to the NIIT.

4. How is the NIIT applied when a non-resident alien or part-year resident alien is treated as a full-year resident?

A Section 6013(g) election treats a non-resident alien married to a US citizen or resident as a US resident for

the entire taxable year for purposes of Chapters 1 and 24. Similarly, Section 6013(h) allows a dual-status individual who is a non-resident alien at the beginning of the year but is a US resident at the end of such taxable year, and who is married to a US citizen or resident, to be treated as a US resident for purposes of Chapters 1 and 24 of the Code for such year if both spouses make the election. The proposed regulations provided for a similar election under Section 6013(g) to also apply for purposes of the NIIT under Chapter 2A. However, no mention was made with respect to an election similar to Section 6013(h).

The final regulations clarify that spouses making the Section 6013(h) or 6013(g) election for purposes of Chapters 1 and 24 may also make the election for purposes of Chapter 2A (i.e., for NIIT purposes). The effect would be that the combined incomes of the US citizen or resident spouse and the dual-status or non-resident spouse would be used for reviewing the NIIT thresholds. The final instructions to Form 8960, issued February 26, 2014, outline how both elections may be made for NIIT purposes.

In addition, it was also unclear what happened when either election was made for regular tax purposes and not for NIIT purposes. The final regulations provide a default treatment pursuant to which US citizens or residents married to nonresident aliens or dual status individuals are treated as married filing separately for purposes of the NIIT. Under this default treatment, the US citizen or resident spouse will be subject to the threshold amount for a married taxpayer filing a separate return, and the nonresident alien spouse will not be subject to the NIIT.

Observation: *This treatment is welcome news for nonresident*

or dual-status aliens and their spouses depending upon their mix of income, although it will likely add complexity to their return preparation process. It may often be favorable not to make these elections for NIIT purposes. Note that the IRS will reconsider this rule if taxpayers are applying it inappropriately.

5. If an individual ‘expatriates’ triggering an exit tax, will such income be subject to NIIT?

When an individual renounces US citizenship or relinquishes a green card that was held for several years or claims foreign residency under a treaty in certain circumstances, he or she may be subject to an exit tax. Under Section 877A, the property of such person (a so-called covered expatriate) is treated as sold for fair market value on the day before the expatriation date. This can result in the individual being taxed in the US on worldwide unrealized gains (among other implications). It was previously unclear whether such deemed sales and resulting gains or losses would be considered as net investment income for purposes of the NIIT. However, the final regulations confirm that such deemed sales shall be regarded as a disposition of property for Section 877A purposes and subject to the NIIT.

Other issues under the new guidance

The above explanation highlights a few significant issues that were clarified by the IRS in the final regulations. However, it is important to note that it is not an exhaustive discussion and the new regulations contain additional guidance on various other issues relevant to globally mobile individuals. For example, the new regulations provide

additional detail on what constitutes net investment income subject to NIIT such as foreign currency gain or loss. Additional details are provided regarding the computation of net gain subject to NIIT and the treatment of certain capital loss, passive activity loss, and investment interest expense carryforwards. In addition, the regulations also describe how certain deductions may be properly allocable and the treatment of income relating to passive foreign investment companies (e.g., some foreign pensions may be treated as such).

The takeaway

Evaluate additional mobility costs

The final regulations clarify many of the issues regarding application of the NIIT to globally mobile citizens and residents. A critical issue is whether foreign tax credits may be used to offset the NIIT liability and unfortunately, the IRS has made it clear that they do not believe a foreign tax credit is allowed. Mobility professionals should determine the resulting impact. A first step is to review company policies for all business units. If a company's mobility policies provide that the company will bear the cost of *any* US tax on the assignee's overall income – not just wages but also investment income, then the imposition of the NIIT could result in unexpected additional tax costs.

For example, an individual on assignment from his home country who is regarded as a US resident for tax purposes who realizes foreign source investment income subject to US federal income tax at 39.6% and foreign income tax at 55% would generally be entitled to fully offset his/her US federal tax liability on such income, resulting in a worldwide income tax rate of 55% on such

income. Because the IRS will not allow the NIIT to be offset by foreign tax credits, this individual's tax rate will likely increase to 58.8 % (i.e., the foreign tax of 55 % plus the 3.8 % NIIT, excluding any benefit of a foreign tax deduction).

Similarly, a US citizen working abroad may fall below the Section 1411(b) threshold amount on a hypothetical ‘stay at home’ basis but above such threshold due to assignment-related benefits. This may result in increased tax equalization costs to the company if non-assignment income is equalized. The 3.8% company responsibility would be in addition to any host-country tax that may apply to the individual's net investment income.

Even in situations where the employer has not made a commitment to tax equalize an inbound assignee on US taxes imposed on investment income, mobility professionals will need to consider the possibility that such individuals may not be aware of this new tax and they should be prepared to answer questions.

Mobility professionals should be proactive in understanding the impact of this tax and whether any changes to mobility policies or other business plans may be appropriate.

Consider communication plans

For those employees currently on assignment and that are tax equalized, the application of NIIT may yield additional tax costs but may also impact future assignments and budgeting. Communication of these future costs to business teams may be appropriate. Even where there is no tax equalization or other tax-reimbursement policy, multinational companies should take steps to ensure that their internationally mobile population is aware of this tax increase on personal income which might lead to double taxation where

investment income is also subject to tax in a foreign country.

The NIIT is not withheld by the employer. However, employees can ask their employers to increase withholding to cover this tax. Mobility program managers may wish to communicate this option to their assignees or point out that they should consider increasing estimated tax payments to the IRS.

Additional complexity likely to arise

Mobility professionals should be aware that computation of the NIIT may add complexity to the tax return preparation process. For example, additional analysis may be necessary to determine optimal positions such as whether to make certain elections

noted above for NIIT purposes (not simply for regular US income tax purposes). Time and analysis may also be needed to address the allocation of deductions, losses, carryovers, and recoveries of tax amounts. Allocation of income between spouses may be needed for NIIT calculation purposes. Other issues noted above may also require additional time.

The effective dates for certain guidance may also add complexity. The NIIT is effective starting for the 2013 calendar tax year. The final regulations are generally effective for taxable years beginning after December 31, 2013 (except for rules applicable to certain trusts). However, taxpayers may rely on either the proposed or final regulations for

the 2013 calendar tax year with certain limitations. Additional time may be needed to consider if provisions under either regulations may be more favorable for the taxpayer.

Moreover, the final Form 8960 for the 2013 tax year released by the IRS appears to be identical to the draft Form 8960 released in August of 2013. However, the final form appears to only reflect the proposed regulations; for example, it only shows a box for taxpayers to check with respect to Section 6013(g) elections and not Section 6013(h) elections. However, the final instructions released by the IRS coordinate the final regulations with the final version of the form.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your regular engagement contact or the following team members in the United States from

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