YEAR-END REVIEW: NET INVESTMENT INCOME TAX

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The Net Investment Income Tax ("N.I.I.T.") was added to the Code on March 30, 2010. It is imposed at a rate of 3.8% of certain net investment income ("Net Investment Income") of individuals, estates and trusts having income above specified triggering amounts. For individuals who are calendar year taxpayers, the tax first became effective in 2013. Thus, the current tax return filing season will be the first time taxpayers feel the effect of the tax. In late 2013, the I.R.S. released final and proposed regulations for the N.I.I.T.[1] These regulations clarify proposals that were issued on December 5, 2012. This article provides a summary of the N.I.I.T. and explains how the new regulations will affect taxpayers.

IN GENERAL

Applicable Thresholds

Individuals will owe the tax if they have Net Investment Income and also have modified adjusted gross income[2] over the following thresholds:

Filing Status	Threshold Amount
Married Taxpayers (Joint Filing)	$250,000
Married Taxpayers (Separate Filing)	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

These amounts are not indexed for inflation.[3]

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1 New regulations were released on November 26, 2013 and published on December 2, 2013.

2 For the N.I.I.T., modified adjusted gross income is adjusted gross income (Form 1040, Line 37) increased by the difference between amounts excluded from gross income under Code §911(a)(1) and the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under Code §911(d)(6) for amounts described in Code §911(a)(1). In the case of taxpayers with income from C.F.C.s and P.F.I.C.s, additional adjustments to their adjusted gross income may be required. See Treas. Reg. §1.1411-10(e).

As long as the modified adjusted gross income does not exceed the foregoing amounts, no N.I.I.T. is due. If the threshold is exceeded, the tax is imposed on the amount of the excess, or if lower, the net investment income. This is illustrated by the following example.

> *Example 1:* An individual taxpayer is single and has $170,000 in wages and $50,000 in dividends. The taxpayer has modified adjusted gross income of $220,000, which is over the statutory threshold of $200,000. The taxpayer will be taxed 3.8% on $20,000 (the amount of modified adjusted gross income which is over the statutory threshold) because that amount is less than the $50,000 of Net Investment Income. The tax is $760.00 (3.8% x $20,000).

Definition of Net Investment Income

In general, investment income includes:

- Interest, dividends, capital gains, rental and royalty income, and non-qualified annuities;
- Income from businesses involved in trading of financial instruments or commodities (*i.e.*, traders); and
- Income from businesses that are passive activities to the taxpayer (within the meaning of Section 469).[4] In broad terms, this generally includes any active business that is carried on by a partnership, an S-corporation, or an L.L.C. in which an individual has invested money but does not actively participate in the business within the meaning of the passive activity loss rules.

Net Investment Income is calculated by allocating certain expenses to gross investment income. The regulations caution that the allocations must be proper. [5] Examples include investment interest expenses, investment advisory, and brokerage fees, expenses related to rental and royalty income, tax preparation fees, fiduciary expenses in the case of an estate or trust, early withdrawal penalties,

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[3] Code §1411(b). See "Net Investment Income Tax FAQs," last updated January 30, 2014, available at: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

[4] The following is not considered investment income: wages, unemployment compensation, operating income from a nonpassive business, Social Security Benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends and distributions from certain Qualified Plans (those described in §§401(a), 403(a), 403(b), 408, 408A, or 457(b). See "Net Investment Income Tax FAQs," Question 9, last updated January 30, 2014, available at: http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

[5] Treas. Reg. §1.1411-4.

net passive activity operating loss carryovers incurred in a prior year and suspended, and state and local income taxes.[6]

The N.I.I.T. will not apply to any amount of gain that is excluded from gross income for regular income tax purposes, such as the principal residence exemption. The full gain is exempt if it does not exceed $250,000 for single individuals and $500,000 in the case of a married couple. This is illustrated by the following example:

> *Example 2:* A, a single filer, earns $210,000 in wages and sells his principal residence for the preceding 10 years for $420,000. A's cost basis in the home is $200,000. A's realized gain on the sale is $220,000. Under Section 121, A may exclude up to $250,000 of gain on the sale. The entire gain is excluded from the N.I.I.T. tax base.

Payment of Estimated Taxes

The N.I.I.T must be taken into account when preparing quarterly estimated tax payments. Under-payment penalties are imposed for shortfalls of estimated tax caused by a failure to consider N.I.I.T. tax when preparing estimates.

Passive Activity and the N.I.I.T.

As mentioned above, the N.I.I.T. applies to trade or business income that arises from a passive activity and not to the active trade or business income categorized as "material participation" income by an individual.

As with the basic passive activity loss disallowance rules, the N.I.I.T. regulations allow a taxpayer the opportunity to group multiple business activities in order to convert passive business activities into active business activities of the individual. By grouping multiple business activities as a single "appropriate economic unit," a taxpayer's hours of participation in one entity can extend to another entity.[7] This causes the combined income to be considered active business income not subject to the N.I.I.T.[8] Factors that suggest activities constituting an appropriate economic unit include:

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and

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6 The I.R.S. indicated in the final regulations that it can still impose further guidance and deductions in the future, but it would not expand on the list of deductions other than the "properly allocated" deductions as indicated above.

7 Treas. Reg. §1.469-4.

8 It is important to note that these groupings cannot be subsequently changed without I.R.S. consent. See Treas. Reg. §1.469-4(e).

- Interdependencies between or among the activities (*i.e.*, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

The application of these factors is illustrated by the following examples:

> *Example 3.* Mr. C has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. There may be more than one reasonable method for grouping Mr. C's activities. Depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity, a movie theater activity and a bakery activity, a Baltimore activity and a Philadelphia activity, or four separate activities.
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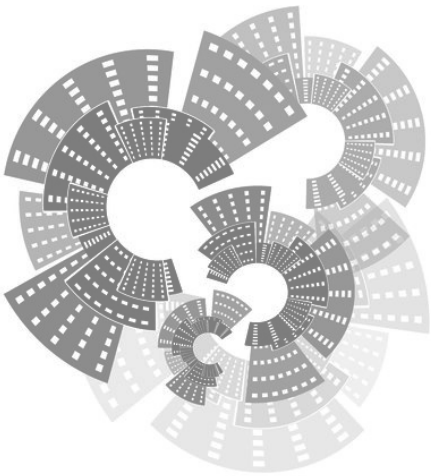
> *Example 4.* Ms. B is a partner in a business that sells non-food items to grocery stores (partnership L). Ms. B also is a partner in a partnership that owns and operates a trucking business (partnership Q). The two partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking business in which Ms. B is involved. Ms. B may appropriately treat L's wholesale activity and Q's trucking activity as a single activity.

Once a taxpayer chooses a particular grouping, it remains in place for all subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.



Real Estate

In the preamble to the final regulations, the I.R.S. acknowledged that "in certain circumstances" the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business under Code §162 (and, therefore, is a trade or business under Code §1411) and thus excluded from the N.I.I.T.

That being said, the I.R.S. has not provided a bright line test of when a rental activity will rise to a trade or business. Instead, the I.R.S. provided several factors when it will actually be a Code §162 trade or business including:

- The type of property (whether commercial/residential);
- The number of properties currently owned;
- Day-to-day involvement of the owner; and
- The type of lease.

Some commentators believe that the lack of clarification in the regulations will ensure that there will be future litigation to determine the issue of when a rental activity is subject to the N.I.I.T.

The I.R.S. cautions that it will scrutinize transactions where the taxpayer takes the position that activities are a trade or business for purposes of the N.I.I.T. but not a trade or business for other provisions in the Code.

Disposition of Partnership Interests or S-Corporation Interests

While the sale of assets from a partnership or S-Corporation may be excluded from the N.I.I.T, the computation is somewhat more complex if the transaction involves the sale of a partnership interest, an L.L.C. interest, or shares of an S-Corporation.[9] First, a determination is made regarding the status of the entity that is being sold. The entity must not be in its entirety a passive entity. Consequently, the following tests must be met:

- The partnership, L.L.C., or S-Corporation must conduct at least one trade or business that does not involve the trading of financial instruments or commodities; and

- At least one of the businesses conducted must not be a passive activity as to the individual.

If the test is met, the gain from the sale of the interest is treated as active only to the extent active gain would be generated by the entity if it sold all its assets. In this manner, look-thru treatment is provided for an outside gain based on the character of the gain that would be recognized from a sale of assets owned by the partnership, L.L.C., or S-Corporation.

INTERNATIONAL TAX ISSUES

Inapplicable to Non-Resident Aliens

Generally, the N.I.I.T does not apply to nonresident, non-citizen individuals ("N.R.N.C."),[10] including dual resident individuals treated as residents of a foreign country under an income tax treaty. There are, of course, exceptions:

- If a N.R.N.C. makes an election to file a joint tax return with a U.S. citizen spouse under Code §6013(g), the N.R.N.C. is treated as a U.S. resident for income tax purposes. The final regulations provide that the N.R.N.C. is not subject to the N.I.I.T. unless a separate election is made to become subject to the tax. If no election is made, the threshold for the U.S. citizen spouse is $125,000, the threshold of a married person filing separately. If a special N.I.I.T. election is made by the N.R.N.C., the joint threshold is bumped up

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[9] Proposed Treas. Reg. §1.1411-7.

[10] Code §1411(e).

"The regulations provide that the foreign tax credit is disallowed with regard to the N.I.I.T.,[1] which if applied in an income tax treaty context, appears to be contrary to the plain meaning of the provisions of the income tax treaty that are addressed to relief from double taxation."

to $250,000.[11] The election is made by checking the box on Part 1 of Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts).

- Dual-status residents who are residents of the U.S. for only a portion of the year will be subject to the N.I.I.T. only with respect to Net Investment Income generated in the residence portion of the year.[12]

Disallowance of the Foreign Tax Credit

The regulations provide that the foreign tax credit is disallowed with regard to the N.I.I.T.,[13] which if applied in an income tax treaty context, appears to be contrary to the plain meaning of the provisions of the income tax treaty that are addressed to relief from double taxation.[14] As a technical matter of treaty interpretation, the N.I.I.T appears to be an income tax "identical or substantially similar" to the income taxes in effect when an existing treaty was enacted.[15] The I.R.S. view is expressed in the preamble to the final regulations, which states that the N.I.I.T. is not an income tax. It further states that if a treaty has similar language to what is provided in Paragraph 2 of Article 23 (Relief from Double Taxation) in the 2006 United States Model Income Tax Convention, then such treaty would not provide an independent basis for a credit against the N.I.I.T. The apparent defect in the I.R.S. reasoning is that, apart from the *ipsa dixit* statement, the N.I.I.T. is a tax on income. Not only is it called a tax on income in Code §1411(a)(1), but the regulations state that income tax concepts apply in determining the N.I.I.T.:

> Except as otherwise provided, all Internal Revenue Code (Code) provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411.[16]

Presumably, all income tax treaties that come into effect on a go-forward basis will include a provision that supports the I.R.S. view, at least with regard to that treaty.

Application to Expatriation

The final regulations confirm that gains resulting from the exit tax upon expatriation are subject to the N.I.I.T.[17]

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11 Treas. Reg. §1.1411-2(a)(2)(iii).

12 Treas. Reg. §1.1411-2(a)(2)(ii). Dual status resident means an individual who is a resident of the United States for a portion of a taxable year and a nonresident alien for the other portion of the taxable year.

13 Treas. Reg. §1.1411-1(e).

14 See, *e.g.,* Article XXIV (Elimination of Double Taxation) of the Canada-U.S. Income Tax Treaty.

15 See, *e.g.*, Article II (Taxes Covered) of the Canada-U.S. Income Tax Treaty.

16 Treas. Reg. §1.1411-1(a).

17 Treas. Reg. §1.1411-4(d)(1).

C.F.C.s and P.F.I.C.s

The regulations provide special rules applicable to income derived from a controlled foreign corporation ("C.F.C.") and a passive foreign investment company ("P.F.I.C.").

Dividends and gains from the sale of shares of a P.F.I.C or a C.F.C. are included in calculating net investment income. The regulations apply to an individual, estate or trust that is a U.S. shareholder of a C.F.C. or a U.S. person that directly or indirectly owns an interest in a qualified electing fund (a "Q.E.F.").[18] Under the general rule, the N.I.I.T. first applies when cash or property is distributed from the Q.E.F. or the C.F.C., even though the income of the C.F.C. or the Q.E.F. may have been included in the taxpayer's income for a previous year. This rule promotes a mismatch in timing between income inclusion for income tax purposes and income inclusion for N.I.I.T. purposes. To address the problem, the regulations permit a taxpayer to accelerate the N.I.I.T. to match the income tax treatment of the item.[19] The election can be performed on an entity-by-entity basis, rather than on a global basis for all C.F.C.s and Q.E.F.s. However, the election can be made only once, not later than the first taxable year beginning after 2013 in which an individual reports income from a C.F.C. or a Q.E.F. and derives sufficient Net Investment Income to be subject to the tax. The regulations are not clear whether the election must be made during the year or in the return for the year. However, the Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts) contains a box in Part 1 that should be checked to make the election.

Foreign Trusts and Estates

The N.I.I.T. applies to a trust or an estate having undistributed Net Investment Income and adjusted gross income that exceeds the dollar amount for the highest tax bracket. For tax year 2014, the highest bracket begins at $12,150.[20]

However, charitable trusts, real estate investment trust, common trust funds, and grantor trusts are exempt from the N.I.I.T. With respect to grantor trusts, if the grantor is a U.S. person, the grantor will be subject to the N.I.I.T. If the grantor is a foreign person, then, generally, the N.I.I.T will not apply to the foreign grantor.

Foreign non-grantor trusts ("F.N.G.T.") are exempt from the N.I.I.T.[21] This may encourage foreign investors in U.S. real property to consider using a foreign trust for this purpose. Existing advice typically recommended the use of a domestic trust, even where the beneficiaries are foreign N.R.N.C.s. The rationale is that once the trust accumulates income and pays tax, no further filing is required by the beneficiaries. With the imposition of the N.I.I.T., current thinking should be reviewed. A 3.8% tax on an accumulated gain may be too hefty a price to pay for the benefit of limited filing obligations.

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18 Treas. Reg. §1.1411-10(c)(1)(i)(A)(1).
19 Treas. Reg. §1.1411-10(g).
20 Rev. Proc. 2013-35.
21 Treas. Reg. §1.1411-3(b)(1)(viii).

In principle, the N.I.I.T. will apply to distributions of accumulated income to U.S. beneficiaries of a F.N.G.T. However, as of the date of this article, the I.R.S. has not issued guidance addressing the implementation of this rule.[22] Consequently, for the time being, U.S. beneficiaries of foreign non-grantor trusts who receive distributions of Net Investment Income will not be subject to the N.I.I.T. The N.I.I.T. does not apply to foreign estates but will apply to distributions made from foreign estates to U.S. beneficiaries at such point as regulatory guidance is provided.

PROCEDURE

Form 8960 (Net Investment Income Tax — Individuals, Estates, and Trusts)

Form 8960 will be used to calculate the N.I.I.T. This form has three parts: Part I, relating to investment income, Part II, relating to investment expenses allocable to investment income and modifications, and Part III, the tax computation. A copy of this form can be found at http://www.irs.gov/pub/irs-pdf/f8960.pdf. Draft instructions are available as of January 6, 2014 at http://www.irs.gov/pub/irs-dft/i8960--dft.pdf.

Reliance on the Former Proposed Regulations

For taxable years beginning before January 1, 2014, taxpayers may rely on the 2012 proposed regulations (published on December 5, 2012), the 2013 proposed regulations (published on December 2, 2013), or the 2013 final regulations (published on December 2, 2013) for purposes of completing Form 8960. However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with the final regulations and that position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, reasonable adjustments must be made to avoid distortions in the N.I.I.T. [23]

CONCLUSION

The final and proposed regulations issued in December 2013 contain over 200 pages of guidance. Nonetheless, many issues remain open and many traps for the unwary exist. If one point has been driven home by the regulations, it is that the tax is here, it is expensive, and investors must live with the cost.

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[22] See §4(d) of the preamble to the final regulations, TD 9644, Tax on net investment income of individuals, 12/16/2013.

[23] See "Net Investment Income Tax FAQs," Question 22, last updated January 30, 2014, *available at:* http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.