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Final Net Investment Income, Additional Medicare Tax Regulations

IRS CLARIFIES NII TAX / ADDITIONAL MEDICARE TAX IN FINAL REGS

Recently released final regulations aim to clarify the Code Sec. 1411 3.8 percent Net Investment Income (NII) tax and Code Sec. 3101(b)(2) 0.9 percent Additional Medicare Tax. The much anticipated NII final regulations come nearly one year after the IRS issued proposed reliance regulations.

Clarifications in the final NII regulations cover income, estimated taxes, real estate rental activities, regrouping under Code Sec. 469, trusts and estates, and much more. The IRS will generally allow taxpayers to rely on either the NII proposed regulations or the final regulations for tax years beginning before January 1, 2014. The final Additional Medicare Tax regulations generally track the proposed regulations with some clarifications for employers. Additionally, the IRS released proposed regulations on the calculation of NII regarding certain types of property, as well as taking a different approach to a much-criticized deemed sale rule for dispositions of active interests in partnerships and S corporations.

IMPACT: The late November release of the final NII regulations leaves little time for 2013 year-end tax planning. Both the NII tax and the Additional Medicare Tax were effective at the beginning of 2013. Also effective at the beginning of 2013 was the 39.6 percent income tax rate and increased rates on qualified dividends and capital gains for higher income taxpayers. All of these events have changed the landscape for higher income taxpayers when compared to tax years before 2013.

IMPACT: Overall, the general framework of the NII tax remains unchanged but the IRS did listen to concerns from taxpayers and practitioners relating to the administration of the NII tax. In some areas, however, the IRS had little room to make changes. The threshold amounts for triggering the NII tax, for example, are set by statute and are not indexed for inflation. The IRS also did not, contrary to many requests, provide a list of income or deduction items that are excluded from the calculation of NII. Some taxpayers, real estate professionals for example, have some relief (a safe harbor) under the final regulations.

COMMENT: The IRS acknowledged that the final NII regulations do not answer every question. They left open the door to future guidance that could address the treatment of particular items of income for NII tax purposes, certain issues related to income, estates and trusts, and more.

COMMENT: At the time this Briefing was posted, the IRS had not yet published final Form 8960, Net Investment Income Tax, and Instructions for the 2013 tax year.

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Background

The Health Care and Education Reconciliation Act (HCERA) created the NII tax to help fund health care reform. For tax years beginning after December 31, 2012, the NII surtax on individuals equals 3.8 percent of the *lesser* of:

- Net investment income for the tax year, or
- The excess, if any of
  - (a) the individual's modified adjusted gross income (MAGI) for the tax year, over
  - (b) the threshold amount.

Under Code Sec. 1411(b), the threshold amount is $250,000 in the case of a taxpayer making a joint return or a surviving spouse, $125,000 in the case of a married taxpayer filing a separate return, and $200,000 in any other case.

IMPACT. Unlike many other tax amounts, the NII thresholds are not indexed for inflation each year. The 2014 amounts will remain the same as for 2013.

Estates and Trusts. Special rules apply to estates and trusts, which are subject to the NII tax on the *lesser* of undistributed NII or the excess of adjusted gross income over the dollar amount at which the highest tax bracket begins.

COMMENT: For 2013, the bracket begins at $11,950. For 2014, it starts at $12,150. Estates and trusts should consider distributing income to beneficiaries to possibly avoid the new 3.8 percent NII tax.

Net Investment Income

Code Sec. 1411(c)(1) is the starting point to define NII. Under this provision,
NII is the sum of:

- ***Category (i) income:*** Gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in Code Sec. 1411(c)(2);
- ***Category (ii) income:*** Other gross income derived from a trade or business described in Code Sec. 1411(c)(2) (a passive activity with respect to the taxpayer or income by a financial trader); and
- ***Category (iii) income:*** Net gain attributable to the disposition of property, other than property held in a trade or business not described in Code Sec. 1411(c)(2), over
- Deductions properly allocable to such gross income or net gain.

"Overall, the general framework of the NII tax remains unchanged but the IRS did listen to concerns from taxpayers and practitioners relating the administration of the NII tax."

Income categories. The Preamble to the regulations refer to each component of investment income as either Category (i), (ii) or (iii), which tracks the Code Sec. 1411(c) (1) subsections, described above.

COMMENT: The final regulations describe in detail the types of income included within each category.

COMMENT: An important NII exception exists for distributions from 401(a), 403(b), 457(a) and other qualified plans and arrangements. Additionally, self-employment income is subject to special rules (both discussed below).

General Clarifications

The IRS described in the Preamble to the final NII tax regulations a number of clarifications, largely in response to questions from taxpayers. They principally involve a determination of what income is subject to the NII tax, what offsetting deductions are allowed, and which taxpayers are subject to the NII tax.

Definition of Net Investment Income

The final regulations and Preamble aim to resolve many of the questions that had been generated by the 2012 proposed regulations over what constitutes "net investment income." The role that the passive activity income/loss rules play in determining net investment income, among other issues, was addressed head on. However, the IRS also rejected certain suggestions aimed toward simplification either through a bright-line test or otherwise as being beyond the scope of the IRS's authority under Code Sec. 1411.

Category (i) Gross Income

The particular issues addressed—if not resolved— within the final regulations that cover Category (i) income include the following:

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Portfolio income. The IRS rejected the suggestion that the definition of portfolio income for purposes of NII adopt in all respects those concepts used under Code Sec. 469.

The IRS in particular pointed to Reg. §1.469-1T(d)(1) as explicitly supporting its position of the more limited scope of Code Sec. 1411 NII portfolio income. That regulation provides that the characterization of items of income or deductions as passive activity gross income (within the meaning of Reg. §1.469-2T(c)) or as passive activity deductions (within the meaning of Reg. §1.469-2T(d)) does not affect the treatment of any item of income or gain under any provision of the Code other than Code Sec. 469.

IMPACT: The interaction of Code Sec. 1411 with Code Sec. 469 is generally limited to the determination of whether those items are attributable to a passive activity within the meaning of Code Sec. 1411(c)(2)(A), the IRS explained in the final regulations.

Ordinary course of trade or business. To qualify for the ordinary course of a trade or business exception that exempts income that is otherwise Category (i) income from the NII tax, two tests must be met:

- The item must be derived in a trade or business not described in Code Sec. 1411(c)(2) (that is, a passive activity with respect to the taxpayer or trading in financial investments or commodities); and
- The item must be derived in the ordinary course of such trade or business.

While the Preamble to the 2012 proposed regulations adopted the definition of trade or business used under Code Sec. 162, the 2012 proposed regulations themselves did not explicitly provide as such. The final regulations now do so.

COMMENT: Like the preamble to the proposed regulations, the final regs defer to case law and administrative guidance applicable to Code Sec. 162 in defining a trade or business under Code Sec. 162.

Hobby-loss. The IRS also declined to expand the scope of the activity being tested as a trade or business by reference to the hobby loss rules under Code Sec 183 or the at-risk limitations under Code Sec. 465.

COMMENT: The IRS reasoned that the rules under these two sections are applied for reasons different from Code Sec. 162 and, therefore, will not be interposed.

Trade or business for rental real estate. The IRS in the preamble to the final regulations 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 Sec. 162 (and, therefore, is a trade or business under Code Sec. 1411 by adoption).

IMPACT. This admission on trade-or-business activity, nevertheless, may prove particularly hollow given the IRS's warning that the rental of a single piece of property does not rise to the level of a trade or business in every case as a matter of law. The IRS pointed to Reg. §1.212-1(h) that provides that the rental of real property can be an example of a for-profit activity under Code Sec. 212 and not a trade or business.

No bright line test. The IRS also refused to provide a bright-line test to determine when a rental activity rises to the level of a Code Sec. 162 trade or business "…due to the large number of factual combinations that exist." The IRS observed some key factual elements among them to include:

- The type of property (commercial real property versus residential condominium versus personal property);
- The number of properties rented;
- The day-to-day involvement of the owner or its agent; and
- The type of rental (net lease versus traditional, short-term versus long-term)

IMPACT: The IRS's position in the final NII tax regulations all but guarantees that a determination of whether a rental activity rises to the level of a trade or business will continue to generate audit controversy and litigation, not only for determining the validity of Code Sec. 162 deductions but now the liability for net investment income tax as well. The 3.8 percent NII tax raises the stakes of guessing incorrectly over whether a trade or business exists; and does so arguably in a different inquiry: one that looks at the income side (Code Sec. 1411) rather than to whether certain deductions (Code Sec. 162) are allowed.

COMMENT. The final regs avoid examples of when a rental activity is a trade or business. In fact, the one example in the final regulations for a real estate activity is one in which a single-property rental does not rise to the level of a trade or business.

Derived in the ordinary course. The IRS mentioned that no special definition of "derived in the ordinary course" is required in determining NII under Code Sec. 1411. The IRS pointed to the lead taken by Code Sec. 469 in this area. Code Sec. 469 exempts from portfolio income through regulations special situations under which interest, dividends, royalties and annuities are considered derived in the ordinary course of a trade or business. If it is not "derived in the ordinary course" but is nevertheless realized "in a trade or business," it is working capital.

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IMPACT: The final regulations do not provide any special guidance to define either "derived in the ordinary course" or, conversely, "working capital," with one concession. In the case of determining whether rents, which are not covered as a special exclusion under Reg. §1.469-2T(c), the IRS explained that case law will determine whether rents are derived in the ordinary course of a trade or business.

COMMENT: If the income is not even considered held in a trade or business, the classification as working capital is irrelevant. If it is working capital, it is not derived from the ordinary course of a trade or business but is income from the investment of working capital within a trade or business under Code Sec. 1411(c)(3).

Income from annuities. In defining "income from an annuity" that is subject to the NII tax, the final regs retain the approach of the proposed regs, which bifurcate NII between Categories (i) and (iii) so that:

- To the extent the sales price of an annuity does not exceed its surrender value, the gain is Category (i) gross income; and
- To the extent the sales price of an annuity exceeds its surrender value, the gain equal to the difference between the basis of the annuity and the surrender value is Category (i) gross income, and the excess of the sales price over the surrender value is considered gain from the disposition of Category (iii) property.

COMMENT: The IRS rejected a suggestion that "gross income from annuities" include only annuity income under Code Sec. 72(a) and not amounts under Code Sec. 72(e) (Amounts Not Received As Annuities), which includes other types of distributions from annuity contracts, such as dividends, that are legitimately includible in gross income. Accordingly, amounts received under annuity contracts that are includible in income under Code Sections 72(a), (b), and (e) are all subject to the NII tax. With respect to charitable gift annuities, the final regulations rejected a suggestion that income distributed post-2012 from CRTs that were funded before 2013 be excluded from the NII tax, reasoning that the same rule applicable to installment sales should apply.

Category (ii) Gross Income

Commentators to the proposed regulations involving other (non-category (i)) gross income from a trading business (a trade or business in trading in financial instruments or commodities) expressed concern that gross income would be included in Category (ii) but the offset of trading losses would only be allowed under Category (iii), with Code Sec. 165 losses taken into account under Category (iii) and subject to a limit on net losses. "To minimize the inconsistencies" between Chapter 1 (especially Code Sec. 165 losses) and Code Sec. 1411 for traders, the final regs assign all trading gains and losses to Category (iii).

The final regulations also allow the deduction of excess losses from the trading business of a Code Sec. 475 trader from other Categories of income.

For a discussion of Category (ii) income from a trade or business that is a passive activity with respect to the taxpayer, see later in this Briefing.

Category (iii) Net Gain Calculation

Since Code Sec. 1411(c)(1)(a)(iii) ("Category (iii)") uses the term "net gain" rather than "net gain or loss," the final regulations retain the rule that net gain within Category (iii) cannot be less than zero. However, the IRS in the final regulations was compelled to allow losses under Code Sec. 1211(b) (excess capital losses up to a maximum $3,000 ($1,500 for married filing separately)) as offsets. But under an ordering rule designed to prevent deducting the same loss twice:

"The IRS acknowledged that the final NII regulations do not answer every question. They left open the door to future guidance."

- First, losses are netted to the extent allowed under the Category (iii) net gain computation (that is, down to zero), and
- Second, only then can they produce a Code Sec. 165 loss, which allows a properly allocable deduction of the $3,000 maximum capital loss under Code Sec. 1211(b).

Net Investment Income Tax Thresholds

FILING STATUS	THRESHOLD
Single	$200,000
Married joint return	$250,000
Married separate return	$125,000
Head of household (with qualifying child)	$200,000
Qualifying widow(er) (with dependent child)	$200,000

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Capital loss carryforwards. The final regulations retain the rule that net gain may take into account capital losses carried over from prior years as a result of Code Sec. 1211(b)(1) (which limited losses in the prior year to $3,000; or $1,500 for married persons filing separately). Beyond that, the final regulations reserve space for the development of carryforward rules as proposed in REG-13084-13 (discussed later in this Briefing).

Properly Allocable Deductions

In computing NII, the sum of Category (i) gross income, Category (ii) gross income and Category (iii) net gain are reduced under Code Sec. 1411(c)(1)(B) by "the deductions allowed by this subtitle [Subtitle A: Income Taxes—Secs. 1-1563] which are properly allocable to such gross income or net gain." Only "properly allocable" deductions are allowed.

The final regulations retain the following, basic list of "properly allocable" deductions as originally set forth in the proposed regs:

- Investment interest expense;
- Investment expenses under Code Sec. 163(d)(4)(C) (expenses directly connected with the production of investment income); and
- State, local and foreign income taxes under Code Sec. 164(a)(3).

In drafting the final regs, the IRS rejected a suggestion to expand the definition of "properly allocable" deductions to generally include all deductions within the Tax Code allowed against any Category (i), (ii) or (iii)-type item. The IRS explained that such a blanket rule would lead to uncertainty and disputes between taxpayers and the IRS.

COMMENT: In a nod toward offering some degree of flexibility, however, the IRS indicated it may publish additional guidance to expand the list of properly allocable deductions to accommodate future changes to the Tax Code.

Allocable taxes. With respect to determining when a method to allocate state, local or foreign taxes imposed on both investment and non-investment income is reasonable, the final regulations do not include additional examples, nor do they adopt similar suggestions aimed at clarification.

IMPACT: As explained in the Preamble, the IRS opted not to provide further examples of reasonable allocation methods for taxes to allow taxpayers flexibility, rather than to imply that only the methods covered in those additional examples would be considered acceptable. However, the IRS did specify that:

- An allocation in the case of estates and trusts between classes of income under Reg §1.652(b)-3 is a reasonable allocation; and
- Foreign taxes may be allowable as deductions in determining NII only if the taxpayer does not choose to take any foreign tax credits under Code Sec. 901 for the same tax year.

Tax refunds. The final regulations specifically address the proper allocation of tax refunds. The deductibility of state income taxes for NII tax purposes is independent of the deductibility of taxes for alternative tax minimum tax (AMT) purposes, according to the IRS.

The final regs clarify that properly allocable deductions are not reduced in the year of recovery if the amount deducted in the prior year did not reduce the amount of the Code Sec. 1411 liability. Nor are properly allocable deductions reduced in the year of recovery if the amount deducted in the prior year is included in net investment income as Category (i), (ii) or (iii) income. Further, in the case of the recovery of a deduction that was allocated between NII and non-NII, the amount taken into account is based on the ratio used to allocate the item in the year of the deduction, even though the ratio may be different in the year of recovery.

Estates and trusts. The final regs also made some changes in the area of estates and trusts. Properly allocable deductions include fiduciary commissions, legal and accounting fees, and other estate and trust administration expenses to the extent allocable to net investment income. Apportionment by trusts and estates between NII and excluded income may be made using "any reasonable method."

Limitations on properly allocable deductions. Despite suggestions otherwise, the final regulations continue to provide that properly allocable deductions that are subject to the Code Sec. 67 two-percent floor on itemized deductions, or the overall "Pease" limitation on itemized deduction under Code Sec. 68 for higher-income individuals, are deducted in determining NII only to the extent deductible after application of these limitations. However, in determining the reasonable approach to applying the Code Secs. 67 and 68 limitations, the final regulations abandon the pro-rata approach of the proposed regs and adopt a recommendation that an ordering rule apply.

COMMENT: This ordering approach applies the limitations to reduce the amount of properly allocable itemized deductions only when such deductions exceed the aggregate amount of the deductions, regardless of whether they are properly allocable, that would be allowed after application of the limitations.

Allocable deductions in excess of investment income. The final regulations hold firm to the rule in the proposed regulations that negative NII (when allocable deductions exceed the three Categories (i, ii and iii) of investment income) cannot be carried over and become an allocable deduction in the subsequent year.

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The proposed regulations provided that, in no event, would a net operating loss (NOL) deduction under Code Sec. 172 be taken into account in determining NII for any tax year. In a taxpayer-friendly switch, however, the final regulations allow at least some portion of an NOL deduction as properly allocable to gross income included in NII. The final regulations delineate a multi-step computation for deter mining this total "section 1411 NOL amount."

Special Situations

The final regulations exclude certain nonpassive items of income from NII in recognition that certain special situations exist. The IRS explained that, given these special circumstances, it is appropriate to "deem" a particular item of income "derived in the ordinary course of a trade or business." These special situations include the treatment of real estate professionals, treatment of self-charged interest, and former passive activities, among others.

Real estate professionals. The IRS rejected suggestions that the rental income of a real estate professional should be excluded from NII, if the professional materially participates in real estate activities. As somewhat of a compromise to critics, however, the final regulations provide a safe harbor test for a real estate professional (within the meaning of Code Sec. 469(c) (7)) who participates in rental real estate activities for more than 500 hours per year. In such cases, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in rental real estate activities for more than 500 hours per year in five of the last 10 tax years (one or more of which may be a tax year prior to the effective date of Code Sec. 1411), then the rental income associated with that activity will be deemed to have been derived in the ordinary course of a trade or business.

COMMENT: The IRS noted that not every real estate professional is necessarily engaged in the trade or business of rental real estate. The IRS reasoned that the use of a taxpayer's Code Sec. 469-determined real estate professional status as a proxy to determine whether rental income is derived in the ordinary course of a trade or business "is not appropriate." Likewise, the use of Code Sec. 469's material participation tests as a proxy to establish regular, continuous and substantial activity under Code Sec 162 for Code Sec. 1411 purposes "is not appropriate."

IMPACT: The IRS emphasized in the Preamble to the final regulations that the 500 hour test represents a safe harbor only. Failure to meet the safe harbor will not prevent a taxpayer from otherwise establishing that the gross rental income or gain or loss is not included in NII.

Self-charged interest. The final regulations carve out a special rule for self-charged interest. Under its passive activity self-charged interest rules, interest income from loans between a taxpayer and passthrough entities owned by the same taxpayer may be recharacterized as passive activity income and would therefore be offset against the passive activity's corresponding interest deduction.

Certain non-passive rental activities. The final regulations also provide a special rule for self-charged rental income. In situations in which rental income under Code Sec. 469 is treated as nonpassive (generally where the taxpayer rents the property for use in an activity in which the taxpayer materially participates, or when the activity is grouped with a non-passive trade or business activity), the gross rental income will be deemed to be derived in the ordinary course of a trade or business and, therefore, exempt for NII tax purposes from NII tax. Gain or loss from the property will also be treated as gain or loss from the disposition of property held in a non-passive trade or business.

Former passive activities. The final regulations clarify the treatment of income, deductions, gains, losses and the use of suspended losses from former passive activities for Code Sec. 1411 purposes. Under a hybrid approach, suspended losses from former passive activities are used in the calculation of NII, but only to the extent of the non-passive income from such former passive activities that is included in NII in that year, the IRS explained.

Code Section 1411 Trade Or Business

Code Sec. 1411(c)(2) describes a trade or business to which NII tax applies. These include:

- A trade or business that is a passive activity (under Code Sec. 469) with respect to the taxpayer; and
- A trade or business of trading in financial instruments or commodities.

Passive activities. Code Sec. 469 provides rules for determining whether a trade or business is a passive activity with respect to a taxpayer. These rules also apply to determine whether a trade or business is a passive activity under the NII tax rules. Foremost among the Code Sec. 469 rules are the material participation requirements, the rules applicable to the rental real estate of real estate professionals and others, and the grouping rules for determining what constitutes a trade or business.

COMMENT: Code Sec. 469 includes a number of income recharacterization rules that treat income from certain passive activities as not being from a passive activity. For these recharacterization rules to apply, the income or gain must be passive activity income under the general rules of Code Sec. 469. Accordingly, non-passive income resulting from a taxpayer's material participation in the activity is not affected by the recharacterization rules.

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The final regulations generally apply the Code Sec. 469 characterization of income and gain, particularly the treatment of portfolio income (which generally is subject to the NII). Income, dividends, etc. that are not derived in the ordinary course of a trade or business are treated as portfolio income and will be included in the first category of NII, under Code Sec. 1411(c)(1)(A). However, income that is recharacterized under the rules for significant participation, for property rented incidentally to development activity, as well as property rented to a non-passive activity, is treated as *not* being from a passive activity and thus is *not* from a trade or business described in Code Sec. 1411(c)(2)(A). This treatment under the final regulations also applies if the gain is not treated as portfolio income under the recharacterization rules.

Trading In Financial Instruments Or Commodities

The final regulations define financial instruments to include stocks and other equity interests, debt, options, forward or futures contracts, notional principal contracts, other derivatives and any other interest in the listed items, including short positions and partial units. In the final regulations, the IRS reiterated that foreign currency gains and losses are treated as NII, unless they are subject to the Self-Employment Contribution Act. The IRS also declined to narrow the definition of financial instrument to exclude "non-financial instruments," such as contracts that reference electricity or weather, and declined to replace the definition of stock with a reference to securities defined, as in the Securities Exchange Act of 1933.

COMMENT. A trader seeks profits from market swings and is engaged in a trade or business if the trading is frequent and substantial. Status as a trader must be distinguished from that of a dealer and an investor.

Working Capital

The 2012 proposed regs referred to working capital as capital that may not be necessary for the immediate conduct of a trade or business. Working capital generally is invested in short-term income producing assets. The NII rules reference the working capital rules in Code Sec. 469. Any income from the investment of working capital is treated as not derived in the ordinary course of a trade or business and is treated as NII. There is an exception for items derived in the ordinary course of a trade or business.

COMMENT. The IRS rejected, as too complex and not administrable, requests to provide a more comprehensive definition of working capital. Congress intended that the NII rules cross-reference the Code Sec. 469 rules and be consistent with them, the IRS explained.

Dispositions of Passthrough Entities

The 2012 proposed regulations described a method for adjusting a transferor's gain or loss from the disposition of a partnership interest or S corporation stock, based on the entity's non-passive assets with respect to the transferor. After commentators questioned the method in the 2012 proposed regulations, the IRS decided to withdraw them and issue new proposed regulations. *These provisions are described in this Briefing's discussion of the proposed regulations.*

Exclusion of Retirement Income

Code Sec. 1411(c)(5) excludes various retirement plan distributions from NII. The exclusion applies to qualified retirement plans and annuity plans; tax-sheltered annuities; IRAs and Roth IRAs; and deferred compensation plans under Code Sec. 457(b). The final regulations clarify that any distribution from a named plan or arrangement is a distribution under Code Sec. 1411, whether or not the payments are treated as a distribution under the qualified plan rules.

Regrouping

Under Code Sec. 469, deductions from passive trade or business activities, to the extent they exceed income from all passive activities (exclusive of portfolio income), may not be deducted against other income. Regulations provide that if a taxpayer's original grouping was clearly inappropriate (or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate) the taxpayer must regroup the activities. The 2012 NII proposed reliance regulations provided taxpayers with the opportunity to regroup their activities in the first tax year beginning after December 31, 2012. The IRS retained the regrouping provision in the final regulations. A regrouping may occur only during the first tax year beginning after December 31, 2012 in which the taxpayer meets the applicable income threshold under Code Sec. 1411 and has NII.

IMPACT: The IRS rejected calls for a "fresh start" for all individuals (and estates and trusts) regardless of whether they have NII income or modified adjusted gross income above the applicable thresholds. The IRS explained that if a taxpayer does not have NII tax liability, there is no reason for regrouping.

IMPACT: A taxpayer can regroup on an amended return but only if (1) the taxpayer was not subject to Code Sec. 1411 on his or her original return or previously amended return, and (2) if, because of a change to the original return, the taxpayer owed tax under Code Sec. 1411 for that tax year. However, regrouping is void if the taxpayer subsequently determines that he or she is not subject to Code Sec. 1411 in that year.

COMMENT: The final regulations include two exceptions to voided elections and examples of the amended return grouping rules.

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IMPACT: The IRS acknowledged concerns from S corporations and partnerships that they should be permitted to change their groupings in light of application of Code Sec. 1411 in any tax year that begins during 2013 or 2014. However, the IRS cautioned that if it would allow regrouping by S corporations and partnerships, taxpayers with no Code Sec. 1411 liability would indirectly be allowed to regroup.

Estimated Taxes

The IRS reiterated in the Preamble to the final regulations that the NII tax is subject to the estimated tax provisions. Some commentators had asked the IRS to provide penalty relief with respect to the 2013 tax year for failure to make appropriate estimated tax payments due to the impact of Code Sec. 1411, or that a taxpayer be allowed to exclude the NII tax from the estimated tax calculation.

COMMENT: The IRS noted that the proposed reliance regulations were released in 2012, giving taxpayers time to become familiar with the NII tax regime.

Foreign Income Taxes

Foreign income taxes, the IRS explained, are allowed as credits only against the tax imposed by Chapter 1 of the Tax Code. The NII tax is imposed by Chapter 2A and, therefore, foreign income taxes (including foreign income, war profits and excess profits taxes) are not creditable against NII tax.

COMMENT: The IRS declined to expressly answer questions from commentators if U.S. income tax treaties may provide an independent basis to credit foreign taxes against NII tax.

Taxpayers subject to NII Tax

Code Sec. 1411 provides that the net investment income tax applies to individuals and estates and trusts, except for nonresident aliens and trusts all of the unexpired interests in which are devoted to one or more of the charitable purposes described in Code Sec. 170(c)(2)(B).

Individuals

The final regulations reiterate that the NII tax applies to an individual who is a citizen or resident of the U.S., but does not apply to a nonresident alien individual. The IRS clarified application of the NII tax to dual resident individuals and dual-status individuals (discussed below).

COMMENT: The final regs also explain that an individual who is a bona fide resident of a U.S. territory is subject to NII tax only if the individual is required to file an income tax return with the U.S. upon application of Code Secs. 931, 932, 933, or 935 and the related regulations. U.S. territory for purposes of the final regulations means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the United States Virgin Islands.

Dual resident individuals. A dual resident taxpayer is an individual who is a resident of both the United States and another country under each country's tax laws. The IRS explained in the Preamble to the final regulations that it weighed how the NII tax should apply to a dual-resident individual who determines that he or she is a resident of a foreign country for tax purposes under an income tax treaty between the U.S. and the foreign jurisdiction and who claims benefits of the treaty as a nonresident of the U.S. Under the final regulations, a dual resident individual is treated as a nonresident for NII tax purposes.

COMMENT: The IRS explained that this treatment is consistent with Reg. §301.7701(b)-7(a)(1), which provides that the individual will be treated as a of computing that individual's U.S. income tax liability.

Dual-status individuals. An individual is a dual-status individual where he or she has been both a resident alien and a nonresident alien in the same tax year. Generally, the individual is taxed on income from all sources for the portion of the year he or she is a resident alien and the individual is taxed on income from U.S. sources only for the portion of the year he or she is a nonresident alien.

The final regulations, the IRS explained, clarify that a dual-status individual is subject to NII tax only with respect to the portion of the year during which the individual is a U.S. resident, and the final regulations clarify this. However, consistent with the rule for tax years of less than 12 months in Reg. §1.1411-2(d)(2), the threshold amount ($200,000, $250,000 or $125,000, as applicable) is not reduced or prorated for a dual status resident. The IRS indicated that it may reconsider this approach if it determines that taxpayers are applying it inappropriately.

Trusts and Estates

The IRS described in the Preamble to the final regulations how the NII tax impacts electing small business trusts, pooled income funds, and other trust arrangements.

Electing small business trusts. The final regulations retain the treatment of electing small business trusts (ESBT) as described in the proposed regulations, which preserved the Chapter 1 treatment of the ESBT as two separate trusts for computational purposes but consolidated the ESBT into a single trust for determining the adjusted gross income threshold under Code Sec. 1411. The IRS rejected arguments that it lacked authority to require this treatment.

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IMPACT: The IRS reiterated that full integration of the S portion and non-S portion into a single trust for Code Sec. 1411 purposes would be administratively burdensome to taxpayers and the government because it would cause the Code Sec. 1411 calculations to differ significantly from such calculations for purposes of Chapter 1, resulting in the need for additional rules to address the computational differences and treatment of separate carryover regimes.

Charitable remainder trusts. In the proposed regulations, the IRS described special computational rules for the classification of the income of and the distributions from charitable remainder trusts, solely for NII tax purposes. The final regulations categorize and distribute NII based on the existing Code Sec. 664 category and class system. This approach, the IRS explained in the Preamble to the final regulations, will apply to the tax years of charitable remainder trusts that begin after December 31, 2012. However, for charitable remainder trusts that relied on the proposed regulations for returns filed before publication of the final regulations, the trust and its beneficiaries do not have to amend their returns to comply with the final regulations.

IMPACT: The IRS explained that commentators requested that the final regulations follow the current rules for Code Sec. 664 that create subclasses in each category of income as the tax rates on certain types of income are changed from time to time. Compliance would be easier under this approach, the commentators told the IRS. The final regulations also reflect the IRS's intention to issue special rules to apply Code Sec. 664 to certain distributions made to charitable remainder trusts owning interests in CFCs and PFICs. The final regulations also reflect the IRS's proposal to enable a charitable remainder trust to choose between the proposed regulations and existing rules under Code Sec. 664.

COMMENT: The final regulations explain that, in the case of a charitable remainder trust with more than one annuity or unitrust beneficiary, the NII is apportioned among the beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the trust for that tax year.

COMMENT: Under the proposed reliance regulations, distributions from a charitable remainder trust to a beneficiary for a tax year would constitute NII in an amount equal to the lesser of the total amount of the distributions for that year, or the current and accumulated net investment income for the charitable remainder trust.

Pooled income funds. The IRS rejected suggestions that pooled income funds be exempt from NII tax. The IRS acknowledged that imposing tax on a pooled income fund will reduce the amount of property that the charitable remainder person will receive.

Foreign trusts. Under the final regulations, Code Sec. 1411 applies to United States beneficiaries that receive distributions of accumulated NII from a foreign trust rather than to the foreign trust itself. The IRS also described in the Preamble to the final regulations the calculation of undistributed NII, how an estate or trust materially participates in an activity, and more.

Foreign estates. The NII tax does not apply to foreign estates, the IRS reiterated. However, this rule does not exempt United States beneficiaries of foreign estates from NII tax on distributions from foreign estates, the IRS explained in the Preamble to the final regulations.

Other arrangements. The final regulations exclude cemetery perpetual care funds from Code Sec. 1411. Also excluded are Alaska Native Settlement Trusts. Qualified funeral trusts are not excluded but the IRS explained that the final regulations provide that the calculation of NII tax will be consistent with the taxation of qualified funeral trusts in chapter 1.

Controlled Foreign Corporations

The final regulations describe how Code Sec. 1411 applies to U.S. shareholders in controlled foreign corporations (CFCs), and passive foreign investment companies (PFICs). The IRS reported that it received a significant number of comments and recommendations on NII taxation and CFCs and PFICs, some of which are highlighted below.

COMMENT: A CFC is any foreign corporation in which either more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly, indirectly, or constructively by U.S. shareholders on any day during the taxable year of such foreign corporation or more than 50 percent of the total value of the stock is owned directly, indirectly or constructively by U.S. shareholders on any day during the tax year of the corporation.

COMMENT. Under Code Sec. 951, U.S. shareholders of a CFC are taxed directly on the CFC's earnings that are invested in certain types of assets in the United States (subject to various restrictions and qualifications).

COMMENT. The IRS reported that it is revising Form 1065, U.S. Return of Partnership Income, and the associated Schedule K-1 to require partnerships and S corporations to provide to their partners and shareholders the information necessary to compute their tax under Code Sec. 1411 with respect to CFCs and PFICs held by partnerships and S corporations.

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Trade or business. The IRS explained in the Preamble to the final regulations that commentators asked if the determination of whether income is "derived from" a trade or business is made by reference to the trade or business of the CFC or the PFIC, or the trade or business of the taxpayer (or pass-through entity in which the taxpayer invests) that holds the CFC or PFIC. The final regulations clarify that the trade or business determination is either based on the taxpayer's trade or business or the trade or business of the pass-through entity in which the taxpayer invests.

Code Sec. 469. The definition of "passive activity" under Code Sec. 469 could encompass holding an interest in a CFC or PFIC. However, under Reg. §1.469-2T(c)(3)(i)(A), amounts included in income under Code Sec. 951(a) and Code Sec. 1293(a) are treated as portfolio income rather than passive income, which caused commentators to wonder if such amounts would be left out of Category (ii) income. The IRS, however, determined that no clarification was needed because the NII regulations did not cross-reference these particular Code Sec. 469 rules.

Elections. Proposed Reg. §1.1411-10(g) allowed individuals, estates, and trusts to elect to include Code Sec. 951 inclusions and Code Sec. 1293 inclusions in NII in the same manner and in the same tax year as the amounts are included in income for chapter 1 purposes. The final regulations allow taxpayers to make this election on an entity-by-entity basis, rather than applying it to all CFCs and QEFs held or subsequently acquired by the taxpayer.

COMMENT: In adopting a recommendation, the IRS explained that the initial election may be made on an original or an amended return, provided that all years affected by the election are still open.

Dividends. The IRS did not revise the final regulations to treat all Code Sec. 951 inclusions and Code Sec. 1293 inclusions as dividends for purposes of Code Sec. 1411. Thus, unless the taxpayer makes an election under Reg. §1.1411-10(g), only distributions of previously taxed earnings and profits attributable to 951 and 1293 inclusions are dividends for NII purposes.

Earnings. The final regulations clarify that if earnings and profits of a CFC were included in the NII of an individual, estate, or trust under a Reg. §1.1411-10(g) election, then a subsequent distribution of the earnings is excluded from the NII of any transferee under rules similar to those that allow a transferee to exclude such amounts from Chapter 1 income. Similar rules are intended to prevent double-counting of earnings and profits when Code Sec. 1248 applies to the transfer of CFC stock. The final regulations also provide new rules to coordinate the election for the 2013 and 2014 tax years.

2013 Net Investment Income Proposed Reliance Regulations

At the same time the IRS issued final regulations on the NII tax, it also issued new (2013) proposed reliance regulations (NPRM REG-130843-13) to address areas that either were not covered in the 2012 proposed regulations, or were subsequently revised. The 2013 proposed regulations address:

- Transfers of pass-through interests with an optional simplified method;
- Code Sec. 707(c) guaranteed payments,
- Code Sec. 736 payments to retirees, and capital loss carryforwards;
- Certain charitable remainder trusts (CRTs) with income from controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs);
- Income recipients of CRTs; and
- Common trust funds, real estate mortgage investment conduits (REMICs), and notional principal contracts (NPCs).

IMPACT: The 2013 proposed regulations carry the same effective date as the 2013 final regulations. However, any provisions adopted when the proposed regulations are finalized that are more restrictive than the proposed regulations would apply prospectively only, the IRS explained. Taxpayers may rely on the proposed regulations until the final regulations are issued.

Comment: Most notably, the IRS withdrew a portion of the 2012 proposed regulations for determining gain and loss from the disposition of an interest in a partnership or S corporation, and issued new proposed regulations in their place.

Pass-through Interests

The 2012 proposed regulations calculated Category (iii) NII from the transfer of a pass-through interest as the gain (or loss) from the disposition of the interest, reduced by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the entity's assets for fair market value.

The 2013 proposed regulations take a different approach, including gain or loss in NII only to the extent of the gain/loss from the deemed sale of the entity's passive assets. These assets, also identified as Code Sec. 1411 property, include any property owned by the entity that, if sold, would result in gain or loss allocable to the interest holder that would be included in determining the partner or shareholder's NII. The IRS explained that the proposed regulations do not provide special rules for partial recognitions, partial dispositions, and distribution transactions, but it requested comments on whether additional rules are required.

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Net Investment Income

Over 50 pages within the final regulations (Reg. §1.1411) and preamble (TD 9644, Nov. 26, 2013) are devoted to clarifying the definition of Net Investment Income set forth in Code Sec. 1411(c):

1411(c)(1)In general.—
The term "net investment income" means the excess (if any) of—
1411(c)(1)(A) the sum of—

1411(c)(1)(A)(i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),

1411(c)(1)(A)(ii) other gross income derived from a trade or business described in paragraph (2), and

1411(c)(1)(A)(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2), over

1411(c)(1)(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

1411(c)(2)Trades and businesses to which tax applies.—
A trade or business is described in this paragraph if such trade or business is—

1411(c)(2)(A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or

1411(c)(2)(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2).

IMPACT: The 2013 proposed rules would apply to a "Section 1411(c)(4) disposition," which is a disposition of an interest in a pass-through entity that is engaged in at least one trade or business (or owns an interest in another pass-through entity engaged in a trade or business) that (i) is not a business of trading in financial instruments or commodities, and (ii) is not a passive activity with respect to the transferor.

COMMENT: The IRS explained in the Preamble to the Proposed Regulations that the purpose of these provisions is to allow gain attributable to non-passive activities to be excluded from NII on the disposition of the interest.

Primary calculation method. Under the proposed 2013 regulations, the transferor's gain (or loss) is generally equal to the lesser of: (i) the amount of gain the transferor recognizes for chapter 1 purposes, or (ii) the transferor's allocable share of net gain from a deemed sale of the pass-through entity's Section 1411 property. A transferor who materially participates in the entity may rely on the valuation requirements under Code Sec. 469 (the passive loss rules), which compute the gain or loss for each activity. In contrast, the 2012 proposed regulations generally required a materially participating transferor to value every asset held by the entity.

IMPACT: The gain or loss is based on a deemed sale of the activities in which the transferor does not materially participate.

Optional Simplified Method

The proposed regulations include an optional simplified method that certain eligible taxpayers may use. The IRS explained that the optional simplified method is available when the amount of gain associated with passive assets owned by the entity is relatively small.

IMPACT: The optional simplified method is not mandatory. The optional simplified method is intended to limit the information sharing burden on pass-through entities by allowing transferors to rely on readily available information to calculate the amount of gain or loss included in NII.

Requirements. The optional simplified method can be used if the transferor's recognized gain on the disposition does not exceed $250,000. The method can also be used if the transferor's gain does not exceed $5 million, if the transferor's historic share (for the year of transfer and the two previous years) of items of income, gain, loss and deduction that the transferor would take into account in calculating NII is five percent or less of the total allocated to the transferor.

Exceptions. Generally, the simplified method is unavailable where the transferor's historical distributive share amounts are less likely to reflect the gain in the pass-through entity's Code Sec. 1411 property on the date of the transferor's disposition, as when (1) the transferor has held the interest for less than 12 months, (2) certain contributions and distributions occur during the year of the transfer and the previous two years (the Section 1411 holding period), (3) the entity has significantly modified the composition of its assets, (4) an S corporation has recently converted from a C corporation, or (5) the transferor makes a partial disposition.

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COMMENT. The IRS requested comments on other possible methods for calculating NII from the transfer of an interest in a pass-through entity that would reduce the burden on the transferor and the entity.

Partnership Payments

Code Sec. 731(a) treats gain from partnership distributions as gain from the sale or exchange of a partnership interest. Similarly, this gain on a partnership distribution is generally treated as net gain that is included in Category (iii) NII. However, certain partnership payments are not treated as being from the sale or exchange of a partnership interest, including Code Sec. 707(c) guaranteed payments and Code Sec. 736 distributions to liquidate a partner's interest.

Code Sec. 707(c) payments. A guaranteed payment is a payment for services or for the use of capital, where the payment does not depend on partnership income. The 2013 proposed regulations exclude payments received for services from NII. However, the IRS reasoned that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as NII.

Code Sec. 736(b) payments. Under Code Sec. 736(b), a payment in exchange for a retiring partner's share of partnership property is generally treated as producing gain or loss from a sale of the partnership interest. The 2013 proposed regulations treat the payments as Category (iii) NII equal to the gain or loss from the disposition of property. However, if the retiring partner materially participates in a partnership trade or business, NII from the payment is reduced under the rules for determining NII from the disposition of a pass-through interest, as discussed above. It does not matter whether the payments are classified as ordinary income or capital gain, the IRS explained.

Code Sec. 736(a) payments. Payments made in exchange for past services or the use of capital are treated as distributive shares or guaranteed payments under Code Sec. 736(a). These can include payments for certain unrealized receivables and goodwill("Code Sec. 736(a) property").

Under Code Sec. 736(a)(1), a liquidating distribution that is determined with regard to the partnership's income is treated as a distributive share of income to the retiring partner. Otherwise , a liquidating distribution is treated as a guaranteed payment under Code Sec. 736(a)(2). Code Sec. 736(a) distributions can include payments for certain unrealized receivables and goodwill ("Code Sec. 736(a) property").Thus, the treatment of the payment for NII purposes depends on whether the distribution is a distribution in exchange for past services, use of capital, or Code Sec. 736(a) property.

Under the proposed regulations, items of income, gain, loss, and deduction attributable to a distributive share under Code Sec. 736(a)(1) are taken into account in computing NII in a manner consistent with the item's chapter 1 character and treatment. Such payments that are unrelated to Section 736(a) property as characterized annually as passive or non-passive by applying the general rules of Code Sec. 469 to each payment in the year received.

The proposed regulations provide that Code Sec. 736(a)(2) payments in exchange for Section 736 property are treated as gain or loss from the disposition of a partnership interest, which is generally included in NII.

COMMENT: The regulations under Code Sec. 469 determine whether Code Sec. 736 liquidating distributions paid to a partner are treated as income (or loss)from a passive activity. If payments to are tiring partner are made over a period of years, the status of the assets and the partner as passive or non-passive may change. The proposed regulations align the Code Sec. 1411 character with the treatment of the payments under Code Sec. 469.

Capital Loss Carry Forwards

In response to comments, the proposed regulations provide an additional special rule needed to address capital loss carry forwards. The proposed regulations create an annual adjustment to capital loss carry forwards, to prevent capital losses excluded from the calculation of NII ("excluded losses") from becoming deductible in future years. Taxpayers must perform the calculation annually, even if they have no NII tax liability for the year.

IMPACT: The IRS explained that the capital loss adjustment accomplishes several goals:

- The rule causes all capital losses incurred prior to 2013 to be allowed when computing Category (iii) NII;
- The rule requires an adjustment only when a taxpayer has excluded losses embedded in a capital loss carry forward;
- The rule provides a mechanism for ordering the use of capital losses to offset gains; and
- The rule allows taxpayers to use capital on-excluded losses for the excess loss deduction under the regulations.

COMMENT: Since capital losses that cannot be deducted in the current year are carried forward to the next year, capital losses incurred in a year prior to the effective date of Code Sec. 1411 generally may be taken into account in computing Category (iii) NII. However, certain capital losses may not be taken into account in determining NII.

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Common Trust Funds (CTFs)

The proposed regulations include a look through rule intended to preclude taxpayers from using common trust funds (CTFs) to re-characterize income that would otherwise be NII, by claiming that CTF ordinary income or loss inclusions are not explicitly NII and therefore are excluded from NII. The look-through rule provides that income or loss from a CTF is NII or a deduction if it would have been NII or deduction to a participant that directly made the investments made by the CTF.

REMICs

Under the proposed regulations, a holder of a REMIC residual interest would include taxable income or net loss from the REMIC in NII.

Notional Principal Contracts

Under the final regulations, gross income from a notional principal contract (NPC),including net income attributable to periodic payments, is NII, but only if the income is derived from a trade or business of trading in financial instruments or commodities. The proposed regulations provide that net income (or net deductions) attributable to periodic and non periodic payments on an NPC is taken into account in determining NII.

IMPACT: The proposed regulations only apply to net income or deductions that are referenced to property that would produce interest, dividends, royalties or rents if held directly by the taxpayer.

Charitable Remainder Trusts

The 2013 proposed regulations provide special rules that apply the Code Sec. 664 category and class system to certain distributions made to CRTs that own interests in CFCs and PFICs that do not make an election under Reg. §1.1411-10(g), to account for the difference between income inclusion under Chapter 1 and under Code Sec. 1411.The proposed regulations also enable a CRT to choose between a simplified method and the existing Code Sec. 664 rules. These latter rules are proposed to be effective for tax years beginning after December 31, 2012.

Coordination. The proposed regulations contain rules that coordinate the NII rules with the Code Sec. 664 rules. First, CFC and PFIC inclusions that are included in gross income under Code Sec. 664 are excluded from NII income in the year that amount is included in income under Code Sec. 664. Second, when a CRT receives a distribution of previously taxed income that is treated as NII income (an NII inclusion amount), the CRT must allocate the income among the categories in Code Sec. 664, such as ordinary income, capital gain, or the "other income" category. The third rule addresses the effect on gain or loss caused by the recognition of income in different years under the CRT and NII rules.

Simplified method. The 2012 proposed regulations provided a simplified method for a CRT to track NII received after December 31, 2012 (the effective date of Code Sec. 1411). Under this method, distributions from a CRT to a beneficiary would consist of NII equal to the lesser of the total distributions for the year, or the current and accumulated NII of the CRT.

IMPACT: If the CRT is established on or after January 1, 2013, a CRT using the simplified method must make the irrevocable election on the CRT's return for the year established. For an older CRT, the election must be made on the CRT's first tax year beginning on or after January 1, 2013.

COMMENT. In some circumstances, the election can be made on an amended return. The IRS indicated that it may eliminate the election from the final regulations if there is no significant interest in using the simplified method.

Effective Dates

The NII tax as enacted by HCERA is effective for tax years beginning after December 31,2012. When the IRS issued proposed regulations in 2012, the IRS explained that taxpayers could rely on the proposed regulations until the effective date of the final regulations. Generally, the final regulations are effective for tax years beginning after December 31,2013. The IRS also provided that taxpayers may rely on either the proposed regulations or the final regulations for purposes of compliance with Code Sec. 1411 for tax years beginning before January 1, 2014.

CAUTION: To the extent a taxpayer takes a position in a tax year beginning before January 1, 2014 that is inconsistent with the final regulations, and the position affects the treatment of one or more items in a tax year beginning after December 31, 2013, the IRS cautioned that the taxpayer must make reasonable adjustments to ensure that Code Sec. 1411 liability is not inappropriately distorted.

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0.9 Percent Additional Medicare Tax

For tax years beginning after December 31,2012, the 0.9 percent Additional Medicare Tax applies to employee compensation and self-employment income above certain threshold amounts. The IRS issued proposed reliance regulations in 2012. In the just-released final regulations, the IRS acknowledged that the Additional Medicare Tax imposes new record-keeping and withholding procedures for employers but rejected suggestions to give employers more time to allow corrections.

COMMENT: Before 2012, the employee share of Medicare tax and the employer share of Medicare tax were the same for a combined tax rate of 2.9 percent. Effective January 1, 2013, the employee- and employer-share of Medicare are no longer automatically the same because of the 0.9 percent Additional Medicare Tax on applicable(higher-income) individuals.

Covered Wages for Additional Medicare Tax

Covered wages for purposes of Additional Medicare Tax include:

- Tips
- Commissions that are part of compensation
- Bonuses
- Most awards and prizes
- Reimbursements under nonaccountable plans
- Back pay awards
- Standby pay
- Gifts by employers to employees
- Cash value of remuneration paid in any medium other than cash

Employee Compensation

The Patient Protection and Affordable Care Act (Affordable Care Act) increased the employee-share of Hospital Insurance (Medicare)by 0.9 percent of FICA wages in excess of certain threshold amounts: $200,000 for single individuals, $250,000 for married couples filing a joint return, and $125,000 for married couples filing separate returns(the amounts are not indexed for inflation).

Example. Martina is single and receives $100,000 in compensation from her employer for calendar year 2013. Martina's wages are not in excess of $200,000, so her employer does not withhold additional Medicare Tax.

Self-Employed Individuals

For tax years beginning after December 31, 2012, the Additional Medicare Tax increases the Medicare tax on self-employment income by an additional 0.9 percent of self-employment income in excess of the applicable threshold amounts ($200,000/$250,000/$125,000). These amounts are reduced, but not below zero, by the amount of FICA wages taken into account in determining Additional Medicare Tax liability.

Employer Withholding

An employer's withholding obligation for Additional Medicare Tax applies only to the extent the employee's wages are in excess of$200,000 in a calendar year. The employer may disregard the amount of wages received by the employee's spouse or from self-employment income or wages received from another employer. Common paymaster rules that determine liability for FICA tax apply.

Comment. The threshold for employer withholding is $200,000. This amount, like the threshold amounts for liability for Additional Medicare Tax, is not indexed for inflation.

Reporting

Individuals report Additional Medicare Tax on Form 1040, U.S. Individual Income Tax Return. Taxpayers may claim credit for any withheld Additional Medicare Tax on Form 1040 and must pay any tax due not paid through withholding or estimated tax payments.

IMPACT: An employee may not request that his or her employer deduct and withhold Additional Medicare Tax on wages of$200,000 or less. The employee may request additional income tax withholding, which will be applied against all taxes shown on the individual's return, including any liability for Additional Medical Tax.

COMMENT: Individual income tax returns for 2013 filed in 2014 are the first individual returns to reflect the Additional Medicare Tax. The IRS has posted a draft version of 2013 Form 8959, Additional Medicare Tax and is expected to finalize Form 8959 before the start of the 2014 filing season.

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Final Regulations

The final Additional Medicare Tax regulations generally track the proposed regulations with some clarifications.

Employer Over/Underpayments

To correct an overpayment of Additional Medicare Tax, an employer may make an adjustment only if it repays or reimburses the employee prior to the end of the calendar year in which the wages/compensation was paid, the IRS explained. To correct an underpayment of Additional Medicare Tax, an employer may make an interest-free adjustment only if the error is ascertained within the calendar year in which the compensation was paid.

IMPACT: Corrections for over/underpayments must be made before the end of the calendar year in which the error was made. Allowing employers time beyond the end of the calendar year would generate confusion for taxpayers, particularly if a taxpayer filed his or her Form 8959 early in the filing season and the employer subsequently made corrections, the IRS observed.

COMMENT: The final regulations also clarify that an employer cannot make an adjustment or file a claim for refund for Additional Medicare Tax withholding when there is a repayment of wages received by an employee in a prior year. The employee, however, may be able to file an amended return claiming a refund of Additional Medicare Tax.

COMMENT: The final regulations refer employers to existing employment tax adjustment procedures for further guidance.

Employer Liability

If an employer deducts less than the correct amount of Additional Medicare Tax, the employer is liable for the correct amount of tax, unless and until the employee pays the tax. The proposed regulations explained that the tax will not be collected from the employer if the employee pays the tax that the employer failed to deduct. The final regulations clarify that the employer is not relieved of its liability for payment of any Additional Medicare Tax required to be withheld unless the employer can show the employee paid the tax.

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