Philadelphia Estate Planning Council

Understanding and Planning for the New Net Investment Income Tax

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In 2010 President Obama signed into law the Patient Protection and Affordable Care Act (PPACA). Enacted as part of the PPACA, a new Medicare tax on unearned income was added which imposes a 3.8% surtax on certain investment income of individuals and estates and trusts beginning January 1, 2013. This tax, which is codified under Internal Revenue Code (IRC) Section 1411, is one of the essential revenue raisers for funding of the PPACA. More commonly known as the net investment income tax (NIIT), the 3.8% surtax will mainly affect high income earning individuals. Many trusts and estates will also be affected as well because the exposure to this new tax begins at much lower income levels for these entities. The new NIIT, along with other significant rate increases taking effect in 2013, will be a surprise to many taxpayers who have not planned for these changes via adequate tax withholding and estimated payments. Fortunately, there are a variety of planning opportunities for individuals, trusts and estates to reduce their exposure to the new NIIT. However, before these strategies can be fully understood, it is important to comprehend the basic mechanics of the NIIT.

Mechanics of the Net Investment Income Tax

For individuals, the 3.8% tax is imposed on the *lesser of:*

a) Net investment income or

b) The excess (if any) of Modified Adjusted Gross Income (MAGI) over the applicable threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others).

This 3.8% tax is *in addition* to any other taxes an individual may be subject to, including regular income tax, alternative minimum tax, self-employment tax and the new 0.9% Additional Medicare Tax on earned income that was also enacted as part of the PPACA.

Modified Adjusted Gross Income, for the purposes of the NIIT, is defined as a taxpayer's Adjusted Gross Income (AGI) increased by any amount of income excluded under the foreign income exclusion. Therefore, for individuals that exclude no foreign income, MAGI essentially means AGI.

It is important to note that individuals whose MAGI does not exceed their applicable threshold amount will not be subject to the NIIT even if they have investment income since the tax is imposed on the *lesser* of the two. That is, only when an individual's MAGI exceeds the applicable threshold amount will the NIIT apply. For example, a retired married couple with AGI of $230,000, composed of $80,000 of dividends, $50,000 of interest, and $100,000 of taxable retirement distributions will not be subject to the 3.8% tax. Even though much of their income would be considered investment income under IRC Section 1411 (covered in detail below) the NIIT will not apply since their MAGI falls below the $250,000 threshold for joint filers.

Accordingly, when planning for clients, it is critical to determine whether the NIIT will be imposed on their net investment income, or their excess MAGI. For individuals having the NIIT applied on the latter, planning strategies that reduce or defer *any* type of income will reduce their NIIT exposure, as MAGI will decrease. A married couple with $300,000 of MAGI ($200,000 of wages and $100,000 of interest and dividends) can take advantage of salary deferrals, 401(k) contributions, deductible IRA contributions, and HSA or FSA contributions to reduce their NIIT. Since the NIIT is imposed on the $50,000 by which their MAGI exceeds the $250,000 threshold as opposed to their $100,000 of investment income, they are not limited in NIIT planning to just reducing their investment income. Therefore, controlling AGI becomes even more valuable in these cases.

Composition of Investment Income

For individuals with less investment income than excess MAGI, determining which income constitutes "net investment income" becomes crucial. It is also where the NIIT formula, which to this point has been black and white, begins to show shades of grey.

As defined under IRC Section 1411(c), net investment income is the sum of three different categories of income:

a) Gross income from interest, dividends, annuities, royalties, and rents,

b) Other gross income derived from a passive activity (e.g. real estate investing) or the trading of financial instruments or commodities, and

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c) Net gain attributable to the disposition of property (other than trade or business property held in an active trade or business).

The sum of these three income categories is then reduced by any deductible investment expenses allowed for the year. This includes investment interest expense, other investment expenses directly connected to the production of investment income, and state, local and foreign taxes allocable to investment income. The NIIT is then applied to this net amount.

As a general rule, income otherwise excluded from gross income is not included in the calculation of investment income. Tax-exempt interest from state and municipal bonds, Roth IRA distributions, the excluded gain from the sale of a principal residence and gains deferred due to nonrecognition rules such as IRC Section 1031 exchanges for real estate are all excluded from the calculation of investment income. Additionally, many forms of retirement income such as distributions from IRA's, pension plans, 401(k) plans, tax sheltered annuities and social security benefits are not considered investment income. Generally, income and loss amounts are netted together *within their category* and cannot fall below zero. That is, losses from passive activities can offset income from other passive activities but such losses cannot offset either gains attributable to the disposition of property or interest, dividends, annuity income, royalty and rental income. There is, however, an exception to this rule for losses attributable to the disposition of property that will be discussed later. Understanding more the composition of these three categories and the statutory definitions of what is included in each category is vital to recognizing effective tax planning opportunities for your clients.

Gross Income from Interest, Dividends, Annuities, Royalties, and Rents

The first category, gross income from interest, dividends, annuities, royalties, and rents, are the types of income usually thought of as "investment" income. However, as noted above, this does not include tax-exempt interest. There are also exceptions for certain interest, dividends, annuities, royalties and rents that are earned in the ordinary course of a business (excluding the trading of financial instruments or commodities) provided the individual is not considered a passive investor of the business. The rules, described in Regulation §1.1411-4, can get complex but there are relief provisions, particularly for some self-employed individuals. An individual whose primary business is loaning money and collecting interest may be able to exclude this interest income from investment income for the purposes of the NIIT. However, an individual whose business primarily provides legal services cannot exclude interest earned on the business's working capital from the definition of investment income. Aside from this narrow exception, gross income from interest, dividends, annuities, royalties and rents are generally included in investment income as one would expect.

Planning ideas surrounding this category of investment income are somewhat limited. Tax-exempt bond interest may yield higher after-tax returns for NIIT paying individuals. Therefore, an individual's exposure to the NIIT should be communicated to their investment advisors so the most tax-efficient asset allocation can be considered.

Passive Activities

The second category of investment income, other gross income derived from a passive activity or a trade or business of trading financial instruments or commodities, is where things become more challenging. Essentially, *all income* derived from a passive activity is included in investment income. Expanding the previous example, a passive partner in a law firm will include as investment income his or her entire portion of income earned by the business, including ordinary income. This provision may effectively include all of the income earned from partnership and S-corporation investments. Accordingly, examination of whether an individual's activities rise to the nonpassive level is increasingly important for NIIT planning.

IRC Section 469 lays out the passive activity rules for determining whether an individual is passive with regard to an activity. The rules, in general, only allow individuals to deduct passive losses up to the amount of passive income earned during the year. Any unused losses are carried forward to the next year, where the suspended losses are again subject to the same limitation. In order for an activity to be considered nonpassive, an individual must prove they "materially participate" in the activity by passing at least one of seven different tests from the regulations. Most of the tests consider the hours the individual participated in the activity. Rental real estate activities are by default deemed passive and individuals have more stringent requirements which must be met before their rental activities can escape passive treatment.

Previously, passive treatment was only significant for individuals with passive losses in excess of passive income. However, the NIIT puts a new focus on the passive activity rules for taxpayers with net passive income, as this income will now be subject to the additional 3.8% tax. Reviewing your clients' participation levels in their activities, evaluating prior passive activity grouping elections and considering new groupings may unveil opportunities to reduce NIIT exposure. While these grouping elections are often irrevocable, NIIT regulations allow a taxpayer to regroup their activities in the first year in which they meet their applicable MAGI threshold and have net investment income. It is also important to note that once an activity escapes passive treatment, a portion of its income may still be included as investment income depending on its character (interest, dividends, rents, royalties).

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Sale and Dispositions of Property

The final category of investment income, net gain attributable to the disposition of property, includes capital gains from the sale of investment securities, and gains resulting from the sale of partnership and S-corporation interests and passive rental properties. However, similar to the exception for interest, dividends, rents and royalties earned in the ordinary course of a trade or business by a nonpassive taxpayer, there is also a similar exception for gains from the disposition of property. Gains that are derived from property held in a trade or business (which is not the trading of financial instruments or commodities) which is not a passive activity of the taxpayer are not included in investment income. For example, in the case of a doctor's office that sells an MRI scanner and incurs a gain, such gain will not be included in investment income by the nonpassive partners.

Additionally, losses attributable to the disposition of property have the unique ability to offset income from the other two categories of investment income in certain situations. Keeping in mind that no category of investment income can fall below zero, losses from the disposition of property that are currently allowed to reduce a taxpayer's income for regular tax purposes are allowed to offset investment income from the other two categories for NIIT purposes. For example, assume a taxpayer has $10,000 of interest income, $20,000 of capital gains and $25,000 of capital losses from the sale of stock. All of the income(loss) is investment income for NIIT purposes with the $10,000 of interest income falling into a different category than the net $5,000 capital loss. Since categories cannot be reduced below zero, it is possible that the taxpayer in this example would not get benefit from the net capital loss and would have to report the full $10,000 of interest income as net investment income. However, as the taxpayer would be allowed to deduct $3,000 of the net capital loss for regular tax purposes, for NIIT purposes, $3,000 of net capital loss may be used to offset the $10,000 of interest income. The unused $2,000 of capital losses will carry forward to the next year for NIIT purposes as well as regular tax purposes. This ability of capital losses to offset other types of investment income becomes even more beneficial when an individual has capital gain income from trade or business assets which is excluded from investment income for NIIT purposes and offsetting capital losses which are considered investment income for NIIT purposes.

More complex rules apply to the sale of partnership or S-corporation interests that are nonpassive to the individual (gains from the sale of passive ownership interests are entirely included in investment income). In general, the amount of gain (or loss) included in investment income is the lesser of: the seller's overall gain or loss determined for regular tax purposes, or the seller's share of hypothetical gain or loss that would be included in investment income because the assets were not held in a trade or business or the activity was passive to the seller. In order to determine the hypothetical gain under these rules, a full valuation of the business's assets and the business's inside tax basis in all of its assets would be required. Fortunately, however, the final regulations provide an optional simplified calculation method for taxpayers that meet certain requirements. The optional simplified method requires a seller to multiply their gain or loss for regular tax purposes by a specified ratio to determine the portion of gain includable in investment income. To qualify for use of the optional simplified method, the taxpayer's gain on disposition must be less than $250,000. If the taxpayer's gain exceeds this amount, but is less than $5,000,000, there are additional requirements that must be met before the optional simplified method can be used. Keep in mind, these specific provisions related to the disposition of partnership and S-corporation interests are still in proposed format and may be subject to additional changes.

Finally, as investment income does not include income that is deferred or excluded, installment sales and IRC Section 1031 transactions of like-kind property may become even more advantageous, as the NIIT tax would be deferred (along with any other regular tax on such gains). Additionally, individuals not normally above their applicable MAGI thresholds, but would otherwise be subject to the tax on account of increased MAGI from the sale of their business, may be able to permanently exclude this gain from the NIIT by recognizing it over several years if it keeps their MAGI below their applicable threshold. However, in these cases it is important not to let the tax tail wag the dog. The terms of the sale of a business should always be a business decision rather than a tax decision. However, this planning may be useful for individuals already leaning toward installment or other deferral strategies.

Trusts, Estates and the Net Investment Income Tax

The mechanics of the NIIT for trusts and estates are very similar to those for individuals. However, two key differences are discussed below.

For trusts and estates, the 3.8% tax is imposed on the *lesser of:*

a) Undistributed net investment income or

b) The excess (if any) of AGI over the applicable threshold amount.

In contrast to individuals, the applicable AGI threshold is dramatically lower for trusts and estates. For trusts and estates the threshold is equal to the dollar amount at which the top tax rate applies for that year; for 2013 this amount is $11,950. While this amount is indirectly adjusted for inflation, it is still significantly lower than the statutory $200,000 and $250,000 thresholds individuals face. The second difference is that only *undistributed* investment income may have the surtax imposed on it. This opens up many planning opportunities discussed below. However, other than these two differences, the same

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rules which apply to individuals also apply to trusts and estates. Interests, dividends, rents, royalties, income from passive activities and gains from the disposition of property collectively represent investment income.

The one major planning opportunity trusts and estates have is the ability to distribute income and remove it from the calculation of investment income. Investment income which is distributed to beneficiaries who individually fall below their applicable MAGI thresholds (which are significantly higher) will pass through the trust or estate NIIT-free and will remain NIIT-free at the individual level as well. For trusts or estates with multiple beneficiaries, the ability to spray income out to all of the beneficiaries can significantly reduce the NIIT at the trust or estate level without substantially increasing any one beneficiary's MAGI. While this strategy can help to reduce estate or trust level NIIT on distributable investment income, capital gains (trust principal) which cannot be distributed will still be subject to the NIIT at the trust or estate level.

For trusts and estates with beneficiaries subject to the NIIT, reconsidering asset allocation and investment strategies with your investment advisor may be beneficial. Income generating investments such as taxable interest paying bonds or dividend paying stocks may yield a higher after-tax return when distributed than growth stocks which are taxed at the trust or estate level when sold. While these income distributing strategies can significantly reduce NIIT exposure, they should be weighed against their costs (loss of asset protection, loss of estate tax or GST protection) before being implemented.

It is also important to note the NIIT is not imposed on grantor trusts. As income from these trusts is reported directly on the grantor's individual return, the income is subject to the NIIT only at the individual level. Additionally, the NIIT is not imposed on IRC Section 501 tax-exempt trusts. However, distributions from these trusts may be included as investment income for in beneficiary's NIIT calculation.

Final Thoughts

While the NIIT is already upon us, planning can still be done to reduce the 3.8% surtax. For trusts and estates, consider distributing investment income to beneficiaries that fall below their applicable NIIT MAGI threshold. Do not forget that the 65-day rule can be elected if distributions cannot be made before the end of 2013. Under this provision, distributions made by March 6, 2014 can be considered as being made in 2013.

In planning for individuals, first determine whether the NIIT is being imposed on investment income or the individual's excess MAGI. This will help define the scope of potential NIIT planning strategies. For individuals with a lower excess MAGI than investment income, consider ways to defer income (including non-investment income) into lower income years or methods to accelerate deductions in arriving at AGI into the current year. Properly planned installment sales can also have the potential to permanently exempt income from the NIIT when the individual's MAGI will remain under their applicable threshold amount in succeeding years under the installment arrangement. On the other hand, reporting the entire gain in the year of sale will most likely cause the individual's MAGI to increase and expose some of their income to the NIIT.

For individuals with less investment income than excess MAGI, only investment income reducing strategies will reduce NIIT exposure. One of the most significant areas of consideration should be the classification of activities as passive or nonpassive. Any income producing activities that can be treated as nonpassive by virtue of grouping elections or increased participation can reduce or eliminate the NIIT. However, this area must be reviewed strategically as grouping elections are often irrevocable and participation levels are frequently scrutinized by the IRS. It is important to keep in mind that, under the proposed regulations, individuals, trusts and estates are allowed a one-time opportunity to regroup their activities in the first year in which the individual or entity has net investment income and their MAGI exceeds the applicable threshold.

Reviewing a client's 2013 exposure to the NIIT can go a long way in eradicating unwanted surprises. Take proactive steps to determine their possible exposure and communicate your client's potential issues on a timely basis. Bear in mind, happy clients make happy advisors, so remember to plan for the NIIT throughout the year.

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