Planning and Preparing for the New 3.8 Percent Net Investment Income Tax

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Taxes are likely to increase for taxpayers earning income from any type of investment, real estate activity, or passive business or partnership, due to a new tax that went into effect for the 2013 tax year. This article explains some of the key features of the tax to discuss with clients and opportunities for tax planning as a result of the changes.

This new tax imposes an additional 3.8 percent tax on the **net investment income** (NII) of certain high-income individuals, trusts and estates. Tax professionals often refer to this tax as the 3.8 Tax, NII Tax, Section 1411 Tax or the Medicare Surtax (not to be confused with the 0.9 percent additional Medicare tax that is now also in effect).

Individuals exceeding modified adjusted gross income threshold amounts are subject to the tax on certain types of income related to investments, passive activity and real estate activity. The individual threshold amounts are $200,000 for single filers, $250,000 for those married filing jointly, and $125,000 for those married filing separately. None of these amounts are inflation adjusted.

Because the NII tax of Section 1411 of the Internal Revenue Code is imposed *in addition to* all other currently existing federal, state and local taxes, it has the potential to significantly increase the amount of money an individual, trust or estate owes the Internal Revenue Service (IRS).

Application to Individuals

Net Investment Income

Make no mistake about it—this new tax is designed to increase the tax bills of certain "high net worth" individuals. Since this additional tax is calculated based on "net investment income," in order to understand how the NII tax can increase a taxpayer's tax liability, we must first address what types of income comprise "net investment income."

There are three general categories of net investment income:

1. Income from non-business investments, such as interest, dividends, annuities, royalties and rents;
2. Income derived from a passive business in which a taxpayer does not materially participate; and
3. Gain from the sale or disposition of property.

Generally, these categories cover types of income earned by sources other than in the ordinary course of a taxpayer's trade or business, such as wages or self-employment income.

Deductions from Net Investment Income

Certain items and expenses can be deducted in order to reduce your NII tax obligation. Deductible items include, but are not limited to, deductions allocable to rents and royalties, net operating losses, investment interest and expenses, state and local income taxes, certain expenses related to annuities, investment advisory and brokerage fees, tax preparation fees, fiduciary expenses, and losses from the disposition of property. Minimizing the amount of income that is subject to the additional NII tax may require a comprehensive review of financial records to ensure that all allowable deductions are considered.

Material Participation

Individuals can avoid being subject to the NII tax if they "materially participate" in their income-producing activities. Whether an individual materially participates in an activity is determined under the passive loss rules of Section 469 of the Code. Perhaps the most common way an individual can materially participate in an activity is by working at least 500 hours in the activity throughout the year. If an individual does not materially participate, then income earned from such activity may be subject to the additional NII tax.

Rental and Leasing Income

For purposes of the NII tax, individuals who rent and lease real estate can seek relief from the scope of the NII tax if they plan their real estate rental activities accordingly.

NII tax can be avoided if an activity producing income requires the "regular and continuous" involvement of the taxpayer. Therefore, those engaged in rental real estate activities may need to comply with case law and Treasury regulations for guidance as to when rental activities rise to the level of being "regular and continuous" to ensure that their rental activities qualify as a trade or business exempt from the tax.

Real Estate Professionals

Individuals qualifying as "real estate professionals" (for purposes of the Section 469 passive loss rules discussed above), often receive tax-friendly treatment of their real estate-related income and may be able to avoid the application of the NII tax. However, qualifying as a real estate professional does not guarantee that such person's income earned from renting and leasing real estate will be exempt. This is because, under the Internal Revenue Code, a person can qualify as a real estate professional for reasons other than by *renting and leasing* property (for example, by developing, constructing or managing real property).

Therefore, real estate professionals should affirmatively establish that they are engaged in the trade or business of rental real estate in order to exclude their rental and leasing income from the NII tax. Establishing that a real estate professional is engaged in the trade

or business of rental real estate requires conclusive evidence that his or her involvement in the real estate rental trade or business is "regular and continuous," as provided by Section 162 of the Code, as well as the case law and administrative guidance that follows.

Fortunately, there is a safe harbor that, if satisfied, will treat a real estate professional as having conclusively established that his or her rental or leasing income is derived in the ordinary course of the trade or business of rental real estate. One way to satisfy the safe harbor is for the real estate professional to have participated in rental real estate activities for more than 500 hours during the year.

Regrouping of Passive Activities

Individuals involved in multiple income producing activities may, in certain circumstances, elect to group those activities together for tax purposes in order to achieve their desired tax goals. Typically, taxpayers can utilize this grouping election one time only. However, the NII rules provide a unique, one-time opportunity for taxpayers to regroup various activities together for purposes of determining whether such activities are passive, and therefore subject to the tax. Since this regrouping election must be made in the first year a taxpayer is subject to the NII tax, some individuals may need to determine, this year, whether regrouping their passive activities will decrease their tax burden.

Application to Trusts and Estates

While the individual thresholds for application of the NII tax kick in at $200,000 (for single filers) or $250,000 (for married filed jointly), trusts and estates are affected whenever undistributed income exceeds $11,950 for tax year 2013 (or $12,150 for 2014). As a result, even relatively small trusts can be affected by the NII tax. Consistent with other chapters of the Code, grantor trusts will be exempt from calculations at the trust level, as all income will be reported at the individual level.

For trusts, the tax is calculated at the lesser of: (a) any undistributed net investment income of the trust for the year, or (b) the adjusted gross income of the trust over the applicable threshold amount for the current year ($11,950 for 2013). Consequently, trustees now have an additional responsibility to consider various factors and circumstances that can affect a trust's exposure to the tax and thereby reduce the trust's ability for asset appreciation.

Undistributed *Net Income*

One of a trustee's powers that can play the largest role in mitigating a trust's exposure to the NII surtax is distributing all the trust's income to its beneficiaries. As long as the beneficiary's income does not exceed the individual threshold, then both the trust and its beneficiary will avoid the ambit of the additional tax. If avoidance of the surtax is a primary consideration, a potential concern of the trustee is managing the equitable distribution from a trust if some beneficiaries are under the individual threshold and others are above. In such a case, a distribution would not help a beneficiary who is already above the threshold avoid the tax.

Asset Selection

Other trusts may not have the ability to distribute 100 percent of trust income. For example, a special needs trust (a trust that may only distribute for supplemental needs of the beneficiary) or trusts designed for asset protection or long-term appreciation limit the trustee's power to distribute the entirety of a trust's income. In these cases, the trustee's powers over investment and asset selection can mitigate a trust's exposure to the tax.

Tax-exempt municipal bonds may be a good investment selection for the tax conscious trustee, as Section 1411 continues to treat these bonds as exempt for the purposes of the NII tax. Trustees may also want to avoid assets that produce large amounts of interest or dividends, and focus more on appreciating assets, which allow for greater control over when gain is recognized. While a trust's capital gains would still be subject to the tax, a trustee can coordinate the recognition of those gains to years when the trustee makes distributions (especially, if the beneficiary will be under the individual threshold amount in the years in which distributions are made).

Also, the trustee should be mindful that the tax is imposed on *net* investment income. Thus, certain allowable deductions can reduce the amount of a trust's net investment income that will be subject to the tax. Trustee and executor fees will reduce a trust's net income, but so may other deductions related to the income producing asset. Subject to the limitations of other Code sections, depreciation of rental property and intangible drilling costs of oil and gas properties could significantly reduce the net income and thereby reduce exposure to the tax.

Partnerships, S Corps and Real Estate Professionals

The NII surtax is designed to capture investment income—i.e., income from passive involvement. Rather than completely redefining investment income, Section 1411 incorporates the Section 469 passive loss rules to determine if a beneficiary's interest is passive. However, Section 469 was originally included to limit *losses* of passive investments, not to define *income*. As a result, the bulk of the extensive recently-released final regulations address an individual's participation in the income producing asset to determine whether the income produced by such asset is passive to the individual.

Essentially, in order for income from a business entity or rental property to be excluded from taxable net investment income, the trust must "materially participate" in the trade or business that produces such income. Generally, a taxpayer materially participates under Section 469 if either the taxpayer or spouse spends more than 500 hours conducting the activity. Additionally, the regulations provide special rules for electing small business trusts (ESBTs) that allow the undistributed income to flow to a person who is treated as an owner of a portion of the trust.

Unfortunately, the ability of a trust to "materially participate" in various businesses and rental real estate is still an unsettled issue. Although some case law supports the beneficiary's ability to claim material participation in the business, recent technical advice memoranda have indicated the Service's unwillingness to recognize the participation by a trust. Specifically, the IRS has rejected the idea that a trust can be a "real estate professional."

Charitable Remainder Trusts

The NII tax presents new incentives for a grantor's ability to manage a consistent income stream by using charitable remainder annuity trusts and unitrusts. This is because Section 1411 excludes these trusts from the NII tax (charitable lead trusts are not excluded, however). Therefore, in addition to the charitable deduction that grantors can claim by the creation of the charitable remainder trust, income that exceeds the amount to be distributed to a beneficiary will not be subject to the NII tax. Because distributions from these trusts are easier to anticipate (especially for annuity trusts), a grantor can structure the distributions to keep his or her distributed income under the individual threshold. The use of the remainder trust is still predicated on the desire of the grantor to leave gifts to charitable organizations as part of his or her estate.

Conclusion

Final regulations on the NII tax released at the end of November, 2013 were substantial. This article addresses several key provisions of those final regulations. However, you should be aware that the IRS has also issued new proposed regulations concerning other important implications of the NII tax, ensuring that this will remain an evolving area of tax law and a hot issue in the upcoming filing season.

As with any new tax or significant changes to the tax Code, the NII tax should prompt a review of a client's financial planning. It presents opportunities to provide clients with up-to-date advice and requires tax professionals to ensure that strategies employed in the past will remain advantageous to clients. Especially in representing trusts and estates, our fiduciary obligation must consider the consequences and respond accordingly.

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