ABA Tax Section

2012 May Meeting

IRS Guidance and the Section 1411 Tax on Net Investment Income ("NII")

Washington, DC

May 11, 2012

Jeanne Sullivan KPMG Washington, DC	Kevin M. Jacobs Ropes & Gray LLP Washington, DC	Matthew A. Stevens Ernst & Young LLP Washington, DC

Section 1411 – "The Back Story"

- The 2010 Health Care Act, P.L. 111-152, added Section 1411 to the Code with an effective date of all taxable years beginning after December 31, 2012.
- The new Medicare Contribution tax is a 3.8% tax imposed on "unearned income" of certain individuals, estates and trusts.
- The goal of the tax is to tax income that would not be subjected to the Medicare hospital insurance tax under FICA and SECA.

Section 1411

The Status of Guidance

Section 1411

The Current State of Play

Section 1411 - Generally

- With respect to an individual, Section 1411 imposes a 3.8% tax on the lesser of:
  - An individual's net investment income and
  - The excess of the individual's modified adjusted gross income over a threshold amount
- With respect to an estate or trust, Section 1411 imposes a 3.8% tax on the lesser of:
  - An estate's or trust's net investment income and
  - The excess of the estate's or trust's adjusted gross income over a threshold amount

Section 1411 Exemptions

- Section 1411 does not apply to:
  - Nonresident aliens (Section 1411(e)(1))
  - A trust where all of the unexpired interests are devoted to one or more of the following purposes (Section 1411(e)(2)):
    - religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

NII Defined (Section 1411(c)(1))

(1) The excess (if any) of

(A) The sum of:

(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)*,

(ii) Other gross income derived from a trade or business described in paragraph (2), and

(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)*, <u>over</u>

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

A trade or business described in paragraph (2)

- A trade or business is described in paragraph (2) if it is:
  - a passive activity (within the meaning of Section 469) with respect to the taxpayer, <u>or</u>
  - a trade or business of trading financial instruments or commodities (as defined in Section 475(e)(1)(B)).

Working Capital

- Income, gain, or loss from the investment of working capital is **<u>not</u>** treated as derived in the ordinary course of a trade or business (including non-passive trade or businesses). (Section 1411(c)(3))
  - Therefore, such income is included in the calculation of NII.

Impact of being “a trade or business described in paragraph (2)”

- Interest, dividends, annuities, royalties, and rents from the trade or business is included in the calculation of NII (clause (i))
- All other gross income is included in the calculation of NII (clause (ii))
- Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property is included in the calculation of NII (clause (iii))

Impact of a trade or business not being "a trade or business described in paragraph (2)"

- Income from the trade or business is not included in the calculation of NII
  - However, remember that income, gain, or loss from the investment of working capital is not treated as derived in the ordinary course of a trade or business.

Impact of not being a trade or business

- Interest, dividends, annuities, royalties, and rents from the trade or business is included in the calculation of NII (clause (i))
- Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property is included in the calculation of NII (clause (iii))

“a trade or business”

- What is a trade or business?
  - Trade or business versus activities entered into for profit. Consider:
    - Whipple v. Commissioner, 373 U.S. 193 (1963)
    - McCullen v. Commissioner, T.C. Memo 1997-280
    - Moller v. United States, 553 F. Supp. 1071 (Fed. Cl. 1982) reversed by 721 F2d 810 (Fed. Cir. 1983)
    - Higgins v. Commissioner, 312 U.S. 212 (1941)
    - Snyder v. Commissioner, 295 U.S. 134 (1935)

Passive Activities

- Any activity in which the taxpayer does not “materially participate.” A taxpayer materially participates in an activity if the taxpayer:
  - Participates in the activity for more than 500 hours;
  - Provides substantially all of the participation in the activity;
  - Participates for more than 100 hours in the activity (“significantly participates”), and either:
    - No other individual participates for more or
    - The sum of all of the taxpayer’s participation in activities in which it materially participates exceeds 500 hours
  - Materially participated in the activity:
    - In 5 of the last 10 taxable years or
    - For any three taxable years (whether or not consecutive) and the activity is a personal service activity;
  - Has regular, continuous, and substantial involvement in the activity and satisfies a facts and circumstances determination.

Passive Activities (continued)

- Are investment activities a passive activity?
- Any participation by a partner or S corporation shareholder in the entities' activities is considered in determining whether the taxpayer "materially participated" except for:
  - Work that is not customarily performed by an owner and for which one of the principal purposes of performing the work is to avoid the disallowance of losses under the passive activity loss rules;
  - Work done as an investor, unless the taxpayer is involved in the day-to-day basis in the activity's management or operations; <u>and</u>
  - Work done by a limited partner, unless the limited partner:
    - Participated in the activity for more than 500 hours;
    - Materially participated in the activity in 5 of the last 10 taxable years; or
    - Materially participated in a personal service activity for three taxable years (whether or not consecutive)

Passive Activities (continued)

Benefit of Being a Passive Activity

- Income from the activity can be offset by passive activity losses.

Disadvantage of Being a Passive Activity

- The activity is classified as a trade or business described in paragraph 2 and therefore, all gross income from the activity is included in the calculation of NII (as opposed to just its interest, dividends, annuities, royalties, and rents).

“a trade or business of trading financial instruments or commodities”

- According to the statute, the word commodity has the same meaning as is given in Section 475(e)(2). However, what constitutes a “financial instrument” is undefined.
  - Consider:
    - Treas. Reg. § 1.1275-6(b)(3)
    - IRC § 731(c)(3)(C)
  - What is a trade or business of trading financial instruments?

Net gain on the disposition of property

- Very broad scope.
- Limited to gains recognized, not realized.
  - For example, if a taxpayer has a gain of $300,000 on the sale of its principal residence, but only includes $50,000 into taxable income (because of the $250,000 exclusion), only $50,000 is included in the NII calculation.

Net gain on the disposition of property (Partnership and S Corporation Interests)

- Includes gain on the disposition of an interest in a partnership or S Corporation to the extent the net gain would be taken into account by the transferor if all property of the partnership or S corporation were sold for FMV before the disposition of such interest. (Section 1411(c)(4))

Net Investment Income Exclusions

- Net Investment Income does not include any:
  - Distributions from qualified plans (Section 1411(c)(5))
  - Amount that is subject to Self-Employment Contributions Act (SECA) tax (Section 1411(c)(6))

Allowable deductions for NII Calculation

- Taxpayers are allowed to subtract deductions to the extent they are allowed and are properly allocable to income included in the calculation of NII.
  - A taxpayer’s allocable investment expenses are allowed as a deduction in calculating NII, only to the extent they exceed 2% of the taxpayer’s AGI.

Threshold Amount (Section 1411(b))

- Individuals (not adjusted for inflation)
  - $250,000 for all married individuals filing a joint return or a surviving spouse
  - $125,000 for all married individuals filing a separate return
  - $200,000 for all other individuals
- Trusts and Estates (adjusted for inflation)
  - The dollar amount at which the highest tax bracket in section 1(e) begins (currently $11,650)

Modified Adjusted Gross Income (Section 1411(d))

- Modified adjusted gross income equals
  - A taxpayer's adjusted gross income <u>plus</u>
  - The excess of
    - The amount of foreign earned income excluded from gross income under section 911(a)(1), <u>minus</u>
    - The amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to excluded foreign earned income.

Some of the Questions Outstanding . . .

- “Net gains”
  - Net of what?
  - Carryover attributes (e.g., capital loss)?
- What characterization dictates for purposes of NII?
  - For example section 1248 or sections 301/302
- Application of section 469 rules
  - Effect of a net passive loss on NII
  - Effect of being a real estate professional
- Application to the carry and investor returns from private equity and hedge funds

Some of the Questions Outstanding . . . (continued)

- Application to tiers of partnerships
  - Determination of characterization of activity
  - Netting of gains and losses
- Deductions “properly allocable” to categories of income subject to Medicare Contribution Tax
  - How to perform allocation
  - What is allocable to net gains
- Treatment of a sale of a partnership interest
  - Practical implications?
- Estimated tax payments

Some of the Questions Outstanding . . . (continued)

- The status of a limited partner who materially participates
- Material participation of estates and trusts
- Application to income from foreign investments
- Return of working capital

Practical Implications

- Watch for the regulations!
- Current year
  - Consider mechanisms of accelerating the recognition of income to avoid the additional tax.
- Next year and beyond
  - Consider mechanisms of stabilizing income recognition
  - Consider the impact on your investments

Practical Implications (continued)

- Professional Implications
  - Choice of investment vehicles
  - Choice of entity
    - Implications of choosing a partnership for tax purposes (i.e., a partnership or an LLC or other entity that elects to be treated as a partnership for federal income tax purposes) versus an S Corporation
  - Drafting of tax provisions within agreements
    - Impact on tax distributions from flow-thru entities

Upcoming Guidance Topics