Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

Client Alert

Current Issues Relevant to Our Clients

January 13, 2014

Final Regulations on 3.8 Percent Net Investment Income Tax -- Action Items

The IRS recently published final regulations concerning the new Medicare tax, imposed beginning with tax year 2013 at a rate of 3.8 percent on net investment income. While the regulations are a welcome development in simplifying and rationalizing many aspects of this new tax regime, they introduce new and complex tax compliance and planning considerations, including various elections for taxpayers to evaluate and navigate -- and in at least some cases, with relatively limited time to do so. Affected persons -- principally the individuals, trusts and estates on whom the tax is directly imposed, but also funds having such investors, as well as advisors and fiduciaries -- should focus soon on the details of these relatively complex regulations if opportunities are to be captured and pitfalls avoided. This alert discusses a miscellany of illustrative items contained in the final regulations for which timing may be particularly sensitive.

The Medicare Tax Generally

The Health Care and Education Reconciliation Act of 2010 enacted a 3.8 percent Medicare contribution tax -- also known as the net investment income tax, or "NIIT" -- beginning with tax year 2013, which is imposed on the net investment income of individuals, estates and trusts if modified adjusted gross income ("MAGI") is over a specified threshold amount. For individuals, the tax is imposed on the lesser of (i) an individual's net investment income for the tax year and (ii) any excess of MAGI for the tax year over a threshold amount; the threshold amount is $200,000 ($250,000 in the case of joint filers and surviving spouses, and $125,000 in the case of a married taxpayer filing separately). The tax is similarly imposed on trust and estate net investment income, but over a lower threshold (*i.e.*, $11,950 for 2013). Investment income is generally defined as interest, dividends, annuities, royalties, and rents, and income derived from a trade or business that is a "passive activity" to the taxpayer. The final regulations provide detailed rules specifying the types of income constituting "net investment income," including within its scope investment income earned through pass-through entities such as investment funds or from any disposition of interests in such funds. It was hoped that final regulations would provide greater guidance on the definition of passivity activity for purposes of NIIT, particularly how it applies to a trust or estate. The IRS only stated that the determination of passive vs. active activities for purposes of Section 1411 is not necessarily identical to Section 469 (dealing with passivity activity losses). Finally, although the tax is in addition to the regular income tax liability, it is taken into account for purposes of calculating estimated tax payments and underpayment penalties.

The Final NIIT Regulations

The recent final NIIT regulations follow and finalize, with substantial revision, proposed NIIT regulations released in late 2012. Because the NIIT as enacted went into effect beginning in 2013, the proposed regulations allowed for taxpayers to rely on their provisions for purposes of determining compliance with the NIIT. However, because the proposed regulations were flawed in various respects, and were substantially revised in the recent final regulations, in many or most cases taxpayers likely will do better in applying the final regulations retroactively, as they are allowed to do -- nonetheless, taxpayers retain the option, at least with respect to 2013, of relying on either the proposed or the final regulations, and will want to consider any differences as applied to their own particular circumstances.

Together with the recent final regulations, the IRS issued additional proposed regulations addressing certain NIIT issues not addressed in the original proposed regulations; these new proposed regulations again allow taxpayers to rely on their provisions, and are likely to be useful to taxpayers in determining NIIT compliance on the several issues they address -- but more on that below.

Estimated Taxes

As noted above, the NIIT is taken into account for purposes of calculating estimated tax payments and

underpayment penalties, and these determinations can be particularly uncertain with respect to net investment income earned through pass-through entities, whose income -- and in particular their net investment income, calculated for the first time for 2013 -- may not be known until well after estimated tax payment due dates. While commentators requested relief, the final regulations do not provide it, as the IRS takes the view that the concern is no greater for NIIT than for regular tax purposes (although this view seems questionable in light of the new uncertainties raised by NIIT computational practices generally and the absence of historical "comparables" from past reporting, as well as the potential partnership pass-through elections discussed below). In any event, NIIT taxpayers earning net investment income, and particularly earning such income through pass-through entities, will need to carefully consider their likely NIIT position in evaluating their remaining estimated tax obligations for 2013, if underpayment penalty exposure is to be managed.

Section 1.1411-10(g) Elections

Individuals, estates and trusts investing in offshore investment funds treated as corporations for federal income tax purposes generally report taxable income from the investment for regular tax purposes based not on actual distributions (as they would for an onshore "C" corporation), but on a flow-through basis (analogous to a partner's reporting of underlying partnership-level income, whether or not distributed). This flow-through treatment occurs automatically with respect to funds constituting "controlled foreign corporations" or "CFCs," and by a (usually advisable) "qualified electing fund" or QEF election with respect to "passive foreign investment company" funds -- so that, in each case when the fund later distributes the "previously taxed" income, the investor is not again subjected to tax on the distribution. However, the NIIT reverses this regular tax treatment -- treating the distribution as taxable, and the earlier earning of income by the fund as not flowing through to the investor's taxable income. Clearly, the disparate treatment between regular tax and the NIIT adds complexity, as well as a need for separate bookkeeping at the fund and shareholder levels to accommodate the determinations necessary for each tax in each fund. As a result, the proposed regulations introduced the possibility of conforming the two taxes, creating an election under former Proposed Treasury Regulations Section 1.1411-10(g) -- sometimes called a "G" election -- allowing for NIIT determination on the basis of flow-through treatment rather than distributions.

The final regulations significantly expand the availability and flexibility of G elections beyond the proposed regulations -- allowing investors in offshore funds considerable choice between retaining potential NIIT deferral (as compared to the regular tax), or instead opting for tax compliance conformity between regular tax and NIIT in the interest of simplicity. In particular, G elections may now be made not just by individuals, trust and estates with respect to their direct and indirect fund holdings, but also by domestic pass-through entities holding interests in underlying offshore funds -- subject, in the case of 2013 elections, to obtaining the "consent" of all pass-through interest holders. The final regulations added further flexibility by allowing taxpayers to make G elections on a fund-by-fund basis -- the proposed regulations providing for a much more limited single taxpayer election, and that applicable to all funds, including those subsequently acquired. Circumscribing this added flexibility, the final regulations in certain circumstances penalize taxpayers making G elections with additional income inclusions and recordkeeping requirements, at least where the G election is made after tax year 2013 (but not for 2013) -- the idea being to limit an otherwise potentially permanent NIIT deferral on undistributed 2013 fund income.

For a taxpayer with more than one or two direct or indirect offshore fund investments, the final NIIT regulations increase exponentially the array of G elections a NIIT taxpayer might potentially consider. At the same time, the 2013 non-election rule adds immediacy to the need to review each fund as a candidate for a 2013, rather than later, G election. (Investors choosing -- at least initially -- to forego a 2013 election and incur the application of the 2013 non-election rule are not free of this time pressure, given the need generally to make any anticipated subsequent G election for a currently held fund no later than the first post-2013 year of either being actually subject to the NIIT, or hypothetically subject to the NITT if a G election were made.) These analytical tasks may not be made any easier or more certain where G elections are also under consideration by intermediate domestic pass-through entities in which NIIT taxpayers are interest holders -- and which entities, notwithstanding interest holders' non-consent, may nonetheless make a fund-level G election based on, *e.g.*, a general partner's pre-existing right to make entity tax elections on behalf of interest holders. And indeed, such intermediate pass-through entities may have little choice but to consider making entity-level elections as a business or fiduciary matter -- given that making no election may mean incurring the additional information reporting burden and expense of providing interest holders on an ongoing basis with additional tax information necessary to accommodate both those who make G elections and those who do not. Whatever they may determine as they make their own G election assessments, as a business matter such intermediate funds also may wish to be in communication with interest holders, so investors can make their own election determinations in an informed and timely manner.

Activity Regrouping Elections

In determining net investment income, the NIIT draws on the so-called "passive activity loss" or PAL rules in grouping "activities." A taxpayer generally may not regroup activities under the PAL rules, but the final

regulations allow for a one-time regrouping in connection with the NIIT, permitting taxpayers to reconsider their PAL grouping elections in light of their NIIT liability. This opportunity, however, is generally available only in the first taxable year after 2012, in which (i) the taxpayer meets the applicable income threshold under the NIIT and (ii) has net investment income -- suggesting that NIIT payers be alert to exploring the potential advantage of a regrouping election if and when the necessary conditions are present.

Section 6013(h) Elections

Under the proposed regulations, married couples consisting of a nonresident alien and a US citizen or resident who elect to file a joint return for regular tax purposes under Code section 6013(g) are similarly allowed to fine jointly for NIIT purposes. The final regulations extend this elective NIIT treatment to couples consisting of a US citizen or resident married to a nonresident who becomes a resident alien, and who elect under Code section 6013(h) to file jointly. The effect of such an election is to include the combined income of the United States citizen or resident spouse and the dual-status spouse in the net investment income calculation, and subject the income of both spouses to the $250,000 threshold amount for taxpayers filing a joint return.

The New Proposed NIIT Regulations

As noted above, the final NIIT regulations were accompanied by a new set of proposed NIIT regulations, addressing topics and issues (and making available certain additional elections) not addressed in last year's proposed regulations -- among them, guaranteed payments, partnership liquidating distributions, common trust fund distributive income share, REMIC residual income, swap income, charitable remainder trusts, and gain or loss from sale of a pass-through interest -- but which are generally not to be retroactively applied, except to the extent taxpayers wish to so apply them. For the most part, it is expected that taxpayers will find these rules helpful, and will adopt retroactive application. However, this effective elective treatment -- just as in the case of the various elections under the final regulations described above -- leaves to taxpayers whether they might do better in their particular 2013 tax reporting situation by opting out of the new proposed regulations' treatment, an analysis better done sooner rather than later.

CRT Simplified Reporting Election

The new proposed regulations make available an election for simplified reporting of net investment income to income beneficiaries of charitable remainder trusts (CRTs). Simplified reporting was first offered in last year's original proposed NIIT regulations, but replaced in the final NIIT regulations at taxpayer request by much more detailed reporting requirements, intended to conform to existing CRT financial and tax reporting, but possibly with more complexity than some CRT taxpayers will prefer -- hence the new proposed regulations' inclusion of a continued option for simplified reporting. However, existing CRTs are generally required to make any simplified reporting election immediately for tax year 2013, and the preamble to the proposed regulations further suggests that the election may not be retained in final regulations, absent sufficient interest among taxpayers for its continued availability. Accordingly, CRTs may wish to consider both the desirability of electing the newly reproposed simplified CRT reporting rules, as well as submitting comments to the IRS should they determine to so elect.

For More Information

To discuss any of the topics covered in this Client Alert, please contact any member of the Tax Department or Trusts and Estates Department, or visit us online at Chapman.com.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material. To the extent that any part of this summary is interpreted as being tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, and (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described.

© 2014 Chapman and Cutler LLP. All rights reserved.

Attorney Advertising Material.