Federal Tax Regulations, Proposed-regulation, Definition of net investment income

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Net Investment Income Tax: Guidance Under Section 1411.—Reg. §§1.1411-0—1.1411-10, providing guidance under section 1411 affecting individuals, estates, and trusts, are proposed (published in the Federal Register on December 5, 2012) (REG-130507-11).

§1.1411-4. Definition of net investment income

(a) ***In general.***— For purposes of section 1411 and the regulations thereunder, net investment income means the excess (if any) of—

(1) The sum of—

(i) Gross income from interest, dividends, annuities, royalties, rents, substitute interest payments, and substitute dividend payments, except to the extent excluded by the ordinary course of a trade or business exception described in paragraph (b) of this section;

(ii) Other gross income derived from a trade or business described in §1.1411-5; and

(iii) Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(3)(ii)(A) for gain or loss attributable to property held in a trade or business not described in §1.1411-5; over

(2) The deductions allowed by subtitle A that are properly allocable to such gross income or net gain (as determined in paragraph (f) of this section).

(b) ***Ordinary course of a trade or business exception.***— Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in §1.1411-5. See §1.1411-6 for rules regarding working capital. To determine whether gross income described in paragraph (a)(1)(i) of this section is derived in a trade or business, the following rules apply.

(1) In the case of an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under §301.7701-3), the determination of whether gross income described in paragraph (a)(1)(i) of this section is derived in a trade or business is made at the individual level.

(2) In the case of an individual, estate, or trust that owns an interest in a trade or business through one or more passthrough entities for Federal tax purposes (for example, through a partnership or S corporation), the determination of whether gross income described in paragraph (a)(1)(i) of this section is—

(i) Derived in a trade or business described in §1.1411-5(a)(1) is made at the owner level; and

(ii) Derived in a trade or business described in §1.1411-5(a)(2) is made at the entity level.

(3) The following examples illustrate the provisions of this paragraph (b).

Example 1. Multiple passthrough entities. A, an individual, owns an interest in UTP, a partnership, which is engaged in a trade or business. UTP owns an interest in LTP, also a partnership, which is not engaged in a trade or business. LTP receives $10,000 in dividends, $5,000 of which is allocated to A through UTP. The $5,000 of dividends is not derived in a trade or business because LTP is not engaged in a trade or business. This is true even though UTP is engaged in a trade or business. Accordingly, the ordinary course of a trade or business exception described in paragraph

(b) of this section does not apply, and A's $5,000 of dividends is net investment income under paragraph (a)(1)(i) of this section.

Example 2. Entity engaged in trading in financial instruments. B, an individual, owns an interest in PRS, a partnership, which is engaged in a trade or business of trading in financial instruments (as defined in §1.1411-5(a)(2)). PRS' trade or business is not a passive activity (within the meaning of section 469) with respect to B. In addition, B is not directly engaged in a trade or business of trading in financial instruments or commodities. PRS earns interest of $50,000, and B's distributive share of the interest is $25,000. Because PRS is engaged in a trade or business described in §1.1411-5(a)(2), the ordinary course of a trade or business exception described in paragraph (b) of this section does not apply, and B's $25,000 distributive share of the interest is net investment income under paragraph (a)(1)(i) of this section.

Example 3. Application of ordinary course of a trade or business exception. C, an individual, owns stock in S corporation, S. S is engaged in a banking trade or business (that is not a trade or business of trading in financial instruments or commodities), and S's trade or business is not a passive activity (within the meaning of section 469) with respect to C. S earns $100,000 of interest in the ordinary course of its trade or business, of which $5,000 is C's pro rata share. Because S is not engaged in a trade or business described in §1.1411-5(a)(2) and because S's trade or business is not a passive activity with respect to C (as described in §1.1411-5(a)(1)), the ordinary course of a trade or business exception described in paragraph (b) of this section applies, and C's $5,000 of interest is not included under paragraph (a)(1)(i) of this section.

(c) *Other gross income from a trade or business described in §1.1411-5*

(1) *Passive activity.*— For a trade or business described in §1.1411-5(a)(1), paragraph (a)(1)(ii) of this section includes other gross income that is not gross income described in paragraph (a)(1)(i) of this section or net gain described in paragraph (a)(1)(iii) of this section. Thus, for a trade or business described in §1.1411-5(a)(1), if an item of gross income or net gain is subject to paragraph (a)(1)(i) or (iii) of this section, it is generally not other gross income described in paragraph (a)(1)(ii) of this section.

(2) *Trading in financial instruments or commodities.*— For a trade or business described in §1.1411-5(a)(2)), paragraph (a)(1)(ii) of this section includes all other gross income that is not gross income described in paragraph (a)(1)(i) of this section. For example, any gain from marking to market under section 475(f) or section 1256 and any realized gain from the disposition of property held in the trade or business is classified as other gross income subject to paragraph (a)(1)(ii) of this section (and not classified as net gain under paragraph (a)(1)(iii) of this section).

(d) *Net gain.*— This paragraph (d) describes special rules for purposes of paragraph (a)(1)(iii) of this section.

(1) *Definition of disposition.*— For purposes of section 1411 and the regulations thereunder, the term *disposition* means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition.

(2) *Limitation.*— The calculation of net gain shall not be less than zero. Losses allowable under section 1211(b) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

(3) *Net gain attributable to the disposition of property*

(i) *In general.*— Net gain attributable to the disposition of property is the gain described in section 61(a)(3) recognized from the disposition of property reduced, but not below zero, by losses deductible under section 165, including losses attributable to casualty, theft, and abandonment or other worthlessness. The rules in subchapter O of chapter 1 and the

regulations thereunder apply. See, for example, §1.61-6(b). Net gain shall include gain or loss attributable to the disposition of property from the investment of working capital. See §1.1411-6.

(ii) *Exception for gain or loss attributable to property held in a trade or business not described in §1.1411-5*

(A) ***General rule.***— Net gain shall not include gain or loss attributable to property (other than property from the investment of working capital (as described in §1.1411-6)) held in a trade or business not described in §1.1411-5.

(B) ***Special rules for determining whether property is held in a trade or business.***— To determine whether net gain described in paragraph (a)(1)(iii) of this section is from property held in a trade or business—

(1) A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. See §1.1411-7 for rules relating to dispositions of interests in partnerships or S corporations.

(2) In the case of an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under §301.7701-3), the determination of whether net gain described in paragraph (a)(1)(iii) of this section is attributable to property held in a trade or business is made at the individual level.

(3) In the case of an individual, estate, or trust that owns an interest in a trade or business through one or more passthrough entities for Federal tax purposes (for example, through a partnership or S corporation), the determination of whether net gain described in paragraph (a)(1)(iii) of this section from such entity is attributable to—

(i) Property held in a trade or business described in §1.1411-5(a)(1) is made at the owner level; and

(ii) Property held in a trade or business described in §1.1411-5(a)(2) is made at the entity level.

(C) ***Example.***— *Gain from rental activity.* A, an unmarried individual, rents a boat to B for $100,000 in Year 1. A's rental activity does not involve the conduct of a section 162 trade or business, but under section 469(c)(2), A's rental activity is a passive activity. In Year 2, A sells the boat to B, and A realizes and recognizes taxable gain attributable to the disposition of the boat of $500,000. Because the exception provided in paragraph (d)(3)(ii)(A) of this section requires a trade or business, this exception is inapplicable, and therefore, A's $500,000 gain will be taken into account under §1.1411-4(a)(1)(iii).

(iii) ***Adjustments to gain or loss attributable to the disposition of interests in a partnership or S corporation.***— Net gain shall be adjusted as provided in §1.1411-7 in the case of the disposition of an interest in a partnership or S corporation.

(e) ***Distributions from estates and trusts.***— Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b), the character of such income constitutes gross income from items described in paragraph (a)(1)(i) and (ii) of this section or net gain attributable to items described in paragraph (a)(1)(iii) of this section, with further computations consistent with the principles of this section, as provided in §1.1411-3(e).

(f) *Properly allocable deductions*
(1) *General rule*

(i) *In general.*— Unless specifically stated otherwise, only properly allocable deductions described in this paragraph (f) may be taken into account in determining net investment income.

(ii) *Limitations and carryovers.*— Deductions allowed under this paragraph (f) shall not exceed the total amount of gross income and net gain described in paragraph (a)(1) of this section. Any deductions described in this paragraph (f) in excess of such gross income and net gain shall not be taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. However, in no event will a net operating loss deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. See *Example 3* of paragraph (h) of this section.

(2) *Properly allocable deductions described in section 62*

(i) *Deductions allocable to gross income from rents and royalties.*— Deductions described in section 62(a)(4) allocable to rents and royalties described in paragraph (a)(1)(i) of this section (and that therefore constitute net investment income) shall be taken into account in determining net investment income.

(ii) *Deductions allocable to gross income from trades or businesses described in §1.1411-5.*— Deductions described in section 62(a)(1) allocable to income from a trade or business described in §1.1411-5 shall be taken into account in determining net investment income to the extent the deductions have not been taken into account in determining self-employment income within the meaning of §1.1411-9.

(iii) *Penalty on early withdrawal of savings.*— Net investment income shall take into account deductions described in section 62(a)(9).

(3) *Properly allocable deductions described in section 63(d)*

(i) *In general.*— Net investment income shall take into account the following itemized deductions:

(A) *Investment interest expense.*— Investment interest (as defined in section 163(d)(3)) to the extent allowed under section 163(d)(1). Any investment interest not allowed under section 163(d)(1) shall be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.

(B) *Investment expenses.*— Investment expenses (as defined in section 163(d)(4)(C)).

(C) *Taxes described in section 164(a)(3).*— In the case of taxes that are deductible under section 164(a)(3) and imposed on both gross income (including net gain) described in §1.1411-4(a)(1) and gross income (as defined under section 61(a)) that is not described in §1.1411-4(a)(1), the portion of the deduction that is properly allocable to gross income (including net gain) described in §1.1411-4(a)(1) may be determined by taxpayers using any reasonable method. For purposes of the prior sentence, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in §1.1411-4(a)(1) to the amount of the taxpayer's gross income (as defined under section 61(a)) is an example of a reasonable method.

(ii) *Application of limitations under sections 67 and 68.*— Any deductions described in this paragraph (f)(3) that are subject to section 67 (the 2-percent floor on miscellaneous itemized deductions) or section 68 (the overall limitation on itemized deductions) are allowed in determining net investment income only to the extent the items are deductible for chapter 1 purposes after the application of sections 67 and 68. For this purpose, section 67 is applied before section 68. The amounts that may be deducted in determining net investment income after the application of sections 67 and 68 shall be determined as described in paragraph (f)(3)(ii)(A) and (B) of this section.

(A) ***Deductions subject to section 67.***— The amount of miscellaneous itemized deductions tentatively deductible in determining net investment income after applying section 67 (but before applying section 68) is determined by multiplying a taxpayer's miscellaneous itemized deductions otherwise allowable under this paragraph (f)(3) by a fraction. The numerator of the fraction is the total miscellaneous itemized deductions allowed after the application of section 67, but before the application of section 68. The denominator of the fraction is the total miscellaneous itemized deductions before the application of sections 67 and 68. See *Example 6* of paragraph (h) of this section.

(B) ***Deductions subject to section 68.***— The amount of itemized deductions allowed in determining net investment income after applying sections 67 and 68 is determined by multiplying a taxpayer's itemized deductions otherwise allowable under this paragraph (f)(3), after the application of section 67, by a fraction. The numerator of the fraction is the total itemized deductions allowed after the application of sections 67 and 68. The denominator of the fraction is the total itemized deductions allowed after the application of section 67, but before the application of section 68. For this purpose, the term itemized deductions does not include any deduction described in section 68(c).

(4) ***Loss deductions.***— Deductions allowed under this paragraph (f) do not include losses described in section 165, whether described in section 62 or section 63(d). Losses deductible under section 165 are deductible only in determining net gain under paragraph (d) of this section, and only to the extent of gains.

(g) ***Special rules for controlled foreign corporations and passive foreign investment companies.***— For purposes of calculating net investment income, additional rules in §1.1411-10(c) apply to an individual, an estate, or a trust that is a United States shareholder that owns an interest in a controlled foreign corporation (within the meaning of section 957(a)) or that is a United States person that directly or indirectly owns an interest in passive foreign investment companies (within the meaning of section 1297(a)).

(h) ***Examples.***— The following examples illustrate the provisions of this section. In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a U.S. citizen, and Year 1 is a taxable year in which section 1411 is in effect.

Example 1. Calculation of net gain. (i) In Year 1, A, an unmarried individual, realizes a capital loss of $40,000 on the sale of P stock and realizes a capital gain of $10,000 on the sale of Q stock, resulting in a net capital loss of $30,000. Both P and Q are C corporations. A has no other capital gain or capital loss in Year 1. In addition, A receives wages of $300,000 and earns $5,000 of gross income from interest. For income tax purposes, under section 1211(b), A may use $3,000 of the net capital loss against other income. Under section 1212(b)(1), the remaining $27,000 is a capital loss carryover. For purposes of determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A's gain of $10,000 on the sale of the Q stock is reduced by A's loss of $40,000 on the sale of the P stock. However, because net gain may not be less than zero, A may not reduce net investment income by the $3,000 of the excess of capital losses over capital gains allowed for income tax purposes under section 1211(b).

(ii) In Year 2, A has a capital gain of $30,000 on the sale of Y stock. Y is a C corporation. A has no other capital gain or capital loss in Year 2. For income tax purposes, A may reduce the $30,000 gain by the Year 1 section 1212(b) $27,000 capital loss carryover. For purposes of determining A's Year 2 net gain under paragraph (a)(1)(iii) of this section, A's $30,000 gain may also be reduced by the $27,000 capital loss carryover from Year 1. Therefore, in Year 2, A has $3,000 of net gain for purposes of paragraph (a)(1)(iii) of this section.

Example 2. Calculation of net gain. The facts are the same as in *Example 1*, except that in Year 1, A also realizes a gain of $20,000 on the sale of Rental Property D, all of which is treated as ordinary income under section 1250. For income tax purposes, under section 1211(b), A may use $3,000 of the net capital loss against other income. Under section 1212(b)(1) the remaining $27,000 is a capital loss carryover. For purposes of determining A's net gain under paragraph (a)(1)(iii) of this section, A's

gain of $10,000 on the sale of the Q stock is reduced by A's loss of $40,000 on the sale of the P stock. A's $20,000 gain on the sale of Rental Property D is reduced to the extent of the $3,000 loss allowed under section 1211(b). Therefore, A's net gain for Year 1 is $17,000 ($20,000 gain treated as ordinary income on the sale of Rental Property D reduced by $3,000 loss allowed under section 1211).

Example 3. Section 172 net operating loss deduction. (i) In Year 1, A, an unmarried individual, has the following items of income and deduction: $60,000 in wages, $20,000 in gross income from a trade or business of trading in financial instruments or commodities (as defined in §1.1411-5(a)(2)) (trading activity), $70,000 in loss from his sole proprietorship (which is not a trade or business described in §1.1411-5), and $30,000 in trading activity expense deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of $20,000. A makes an election under section 172(b)(3) to waive the carryback period for this net operating loss.

(ii) For purposes of section 1411, A's net investment income for Year 1 is the excess (if any) of the $20,000 in gross income from the trading activity over the $30,000 deduction for the trading activity expenses. Net investment income cannot be less than zero for a taxable year. Therefore, A's net investment income for Year 1 is $0.

(iii) For Year 2, A has $200,000 of wages, $100,000 of gross income from the trading activity, $80,000 of income from his sole proprietorship, and $10,000 in trading activity expense deductions. For income tax purposes, A's $20,000 net operating loss carryover from Year 1 will be allowed as a deduction. In addition, under §1.1411-2(c), A's Year 1 $20,000 net operating loss will be allowed as a deduction in computing A's Year 2 modified adjusted gross income.

(iv) For purposes of section 1411, A's $20,000 net operating loss carryover from Year 1 is not allowed in computing A's Year 2 net investment income. As a result, A's Year 2 net investment income is $90,000 ($100,000 gross income from the trading activity minus the $10,000 of trading activity expenses).

Example 4. Section 121(a) exclusion. (i) In Year 1, A, an unmarried individual, sells a house that he has owned and used as his principal residence for five years and realizes $200,000 in gain. In addition to the gain realized from the sale of his principal residence, A also realizes $7,000 in long-term capital gain. A has a $5,000 short-term capital loss carryover from a year preceding the effective date of section 1411.

(ii) For income tax purposes, under section 121(a), A excludes the $200,000 gain realized from the sale of his principal residence from his Year 1 gross income. In determining A's Year 1 adjusted gross income, A also reduces the $7,000 capital gain by the $5,000 capital loss carryover allowed under section 1211(b).

(iii) For section 1411 purposes, under section 121(a), A excludes the $200,000 gain realized from the sale of his principal residence from his Year 1 gross income and, consequently, net investment income. In determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A reduces the $7,000 capital gain by the $5,000 capital loss carryover allowed under section 1211(b).

Example 5. Section 163(d) limitation. (i) In Year 1, A, an unmarried individual, pays interest of $4,000 on debt incurred to purchase stock. Under §1.163-8T, this interest is allocable to the stock and is investment interest within the meaning of section 163(d)(3). A has no investment income as defined by section 163(d)(4). A has $10,000 of income from a trade or business that is a passive activity (as defined in §1.1411-5(a)(1)) with respect to A. For income tax purposes, under section 163(d)(1) A may not deduct the $4,000 investment interest in Year 1. Under section 163(d)(2), the $4,000 investment interest is a carryforward of disallowed interest that is treated as investment interest paid by A in the succeeding taxable year. Similarly, for purposes of determining A's Year 1 net investment income, A may not deduct the $4,000 investment interest.

(ii) In Year 2, A has $5,000 of section 163(d)(4) net investment income. For both income tax purposes and for determining section 1411 net investment income, A's $4,000 carryforward of interest expense disallowed in Year 1 may be deducted in Year 2.

Example 6. Sections 67 and 68 limitations on itemized deductions. (i) A, an unmarried individual, has adjusted gross income in Year 1 as follows:

Wages	$1,600,000
Interest income	400,000
Adjusted gross income	$2,000,000

In addition, A has the following items of expense qualifying as itemized deductions:

Investment expenses	$70,000
Job-related expenses	30,000
Investment interest expense	80,000
State income taxes	120,000

A's investment expenses and job-related expenses are miscellaneous itemized deductions. In addition, A's investment interest expense and investment expenses are properly allocable to net investment income (within the meaning of this section). A's job-related expenses are not properly allocable to net investment income. Of the state income tax expense, $20,000 is properly allocable to net investment income and $100,000 is not properly allocable to net investment income.

(ii) A's 2-percent floor under section 67 is $40,000 (2 percent of $2,000,000). For Year 1, assume the section 68 limitation starts at adjusted gross income of $200,000. The section 68 overall limitation disallows $54,000 of A's itemized deductions that are subject to section 68 (3 percent of the excess of $2,000,000 adjusted gross income over the $200,000 limitation threshold).

(iii) (A) A's total miscellaneous itemized deductions allowable before the application of section 67 is $100,000 ($70,000 in investment expenses plus $30,000 in job-related expenses), and the total miscellaneous deductions allowed after the application of section 67 is $60,000 ($100,000 minus $40,000).

(B) The amount of the deduction allowed for investment expenses after the application of section 67 is computed as follows:

$$\$70{,}000 \times \frac{\$60{,}000}{\$100{,}000} = \$42{,}000$$

(C) The amount of the deduction allowed for job-related expenses after the application of section 67 is computed as follows:

$$\$30{,}000 \times \frac{\$60{,}000}{\$100{,}000} = \$18{,}000$$

(iv) (A) Under section 68, the $80,000 deduction for the investment interest expense is not subject to the section 68 limitation on itemized deductions.

(B) A's itemized deductions subject to the limitation under section 68 and allowed after application of section 67, but before the application of section 68, are the following:

Investment expenses	$42,000
Job-related expenses	18,000
State income tax	$120,000
Deductions subject to section 68	$180,000

(C) Of A's itemized deductions that are subject to the limitation under section 68, the amount allowed after the application of section 68 is $126,000 ($180,000 minus the $54,000 disallowed in paragraph (ii) of this *Example 6*).

(D) The amount of the investment expense deduction allowed after the application of section 68 is determined as follows:

$$\$42{,}000 \times \frac{\$126{,}000}{\$180{,}000} = \$29{,}400$$

(E) The amount of the state income tax deduction allowed after the application of section 68 and properly allocable to net investment income is determined as follows:

$$\$20{,}000 \times \frac{\$126{,}000}{\$180{,}000} = \$14{,}000$$

(F) The itemized deductions allowed after applying sections 67 and 68 and properly allocable to A's net investment income are the following:

Investment interest expense	$80,000
Investment expenses	29,400
State income taxes	14,000
Itemized deductions properly allocable to net investment income	$123,400

(G) The amount of the state income tax deduction allowed after the application of section 68 and not properly allocable to net investment income is determined as follows:

$$\$100{,}000 \times \frac{\$126{,}000}{\$180{,}000} = \$70{,}000$$

(H) The job-related expenses deduction and $70,000 of the state income tax deduction are not properly allocable deductions for purposes of section 1411.

Example 7. Section 1031 like-kind exchange. (i) In Year 1, A, an unmarried individual who is not a dealer in real estate, purchases Greenacre, a piece of undeveloped land, for $10,000. A intends to hold Greenacre for investment.

(ii) In Year 3, A enters into an exchange in which he transfers Greenacre, now valued at $20,000, and $5,000 cash for Blackacre, another piece of undeveloped land, which has a fair market value of $25,000. The exchange is a transaction for which no gain or loss is recognized under section 1031.

(iii) In Year 3, for income tax purposes A does not recognize any gain from the exchange of Greenacre for Blackacre. A's basis in Blackacre is $15,000 ($10,000 substituted basis in Greenacre plus $5,000 additional cost of acquisition). For purposes of section 1411, A's net investment income for Year 3 does not include any realized gain from the exchange of Greenacre for Blackacre.

(iv) In Year 5, A sells Blackacre to an unrelated party for $35,000 in cash.

(v) In Year 5, for income tax purposes B recognizes capital gain of $20,000 ($35,000 sale price minus $15,000 basis). For purposes of section 1411, A's net investment income includes the $20,000 gain recognized from the sale of Blackacre.

(i) *Effective/applicability date.*— This section applies to taxable years beginning after December 31, 2013. [Reg. §1.1411-4.]

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Analysis of Post-2012 Net Investment Income and Additional Medicare Taxes

December 7, 2012

Special Report

HIGHLIGHTS

- 3.8% Net Investment Tax Broadly Applied
- Comprehensive Regs Immediately Useful
- Favorable Passive Activity Grouping Election
- Special Election For Small Business Trusts
- Deemed Sales Passthrough Exception
- Mandatory 0.9% Medicare Tax Withholding
- Self-Employment Situations Addressed

INSIDE

Reliance Regs Tackle New 3.8 Percent Net Investment Income Tax And 0.9 Percent Additional Medicare Tax

The IRS has issued long-awaited and much-needed proposed reliance regulations on the operation of the two new surtaxes imposed under 2010 health care legislation: the 3.8 percent Net Investment Income (NII) Tax under Code Sec. 1411 and the 0.9 percent Additional Medicare Tax under Code Secs. 3101(b)(2) and 1401. Both surtaxes are scheduled to spring into full effect on January 1, 2013. The proposed reliance regs —and frequently asked questions (FAQs) on the IRS website— seek to address many of the gaps in application of these surtaxes that have been questioned by tax professionals, employers and taxpayers. At the same time, the proposed reliance regs create new questions about application of the surtaxes. The guidance on each of these new surtaxes is extensive and is immediately critical for affected taxpayers.

IMPACT: *Immediate action is advisable on a number of fronts. Year-end tax planning may indicate the need to accelerate income otherwise subject to one or both of the surtaxes. Employers may need to adjust their payroll practices immediately for certain employees on January 1, 2013. Investment strategies and asset allocations may need revisiting as may use of deferred compensation plans. Elections pursuant to the proposed NII regs should be considered. Planning is further complicated by uncertainty over the fate of the Bush-era tax cuts after 2012: sunset of those rates for higher-income taxpayers starting in 2013 could mean a combined income and NII surtax rate as much as 43.4 percent on investments, and an additional 0.9 in Additional Medicare Tax on top of a possible 39.6 percent rate on wages and other income.*

COMMENT: *Some taxpayers and employers delayed preparing for the new NII surtax and the Additional Medicare Tax, waiting to see if the U.S. Supreme Court would uphold the 2010 health care legislation and/or if the GOP would win the White House. The Supreme Court upheld the legislation (except for some provisions relating to Medicaid) in June 2012. Any remaining prospects for repeal or rollback of the 2010 health care legislation were diminished with Mitt Romney's loss to President Obama. Of course, Congress and the White House could revisit the NII surtax and the Additional Medicare Tax as part of comprehensive tax reform discussions in 2013.*

Reliance Regulation Status

Both sets of regs (NII and Additional Medicare Tax) are proposed and as such, are subject to a public comment and reassessment process before they are finalized. The proposed regs are generally proposed to be effective for tax years beginning after calendar year 2013, and the IRS has indicated its intention to issue final regs sometime in 2013. In the meantime, the IRS stated that taxpayers may rely on the proposed regs. However, the IRS warns bluntly against any attempt to take advantage of unintentional loopholes in its language that the IRS drafters did not catch. In the preamble to the NII proposed reliance regs in particular, the IRS puts aggressive tax planning on notice that it will

review transactions that manipulate net investment income to avoid the new surtax, and will, "in appropriate circumstances ... challenge such transactions based on applicable statutes and judicial doctrines."

THE 3.8 PERCENT NII SURTAX CALCULATION

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
  (i) the individual's modified adjusted gross income (MAGI) for the tax year, over
  (ii) the threshold amount.

The threshold amount, as defined under Code Sec. 1411(b), means:

- $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: *These threshold amounts are not indexed for inflation. Consequently, the number of affected taxpayers is expected to increase over time because of inflation. Congress could revise the thresholds in the future to reflect inflation or choose to index the thresholds for inflation. At this time, however, there appear to be no plans in Congress or the Obama administration to index the thresholds for inflation.*

EXAMPLE: *Alyce, an unmarried U.S. citizen, has MAGI of $220,000 and $50,000 of NII. Alyce would pay $760, the 3.8 percent NII tax on $20,000.*

COMMENT: *Trusts and estates are also subject to the NII surtax but operate under a different set of rules in connection with NII base and threshold amounts. (See Trusts and Estates, below).*

MAGI. MAGI for purposes of the NII surtax computation is defined under Code Sec. 1411(d) as adjusted gross income without a Code Sec 911(a)(1) foreign earned income exclusion or Code Sec. 911(d)(6) offset. The proposed reliance regs further explain that adjusted gross income for individuals follows the normal AGI definition under Code Sec. 62 (and likewise, AGI under Code Sec. 67(e) for estates and trusts). However, the proposed reliance regs caution that additional adjustments to AGI may be required because of ownership interests (for example, investments) in controlled foreign corporations or passive foreign investment companies (Prop. Reg. §1.1411-1(b)).

> "Taxpayers may rely on the proposed regs. However, the IRS warns bluntly against any attempt to take advantage of unintentional loopholes in its language that the IRS drafters did not catch."

Short tax years. The proposed reliance regs explain that a threshold amount is generally not prorated in the case of a short tax year; for example, because of death (Prop. Reg. §1.1411-2(d)(2)). However, if the short year is the result of a change of annual accounting period, the proposed reliance regs generally require reduction of the applicable threshold amount to an amount that bears the same ratio to the full threshold amount as the number of months in the short period bears to twelve (Prop. Reg. §1.1411-2(d)(2)(ii)).

NET INVESTMENT INCOME

At the heart of the NII surtax proposed reliance regs are efforts by the IRS to more precisely define "net investment income" subject to the 3.8 percent tax.

COMMENT: *The IRS explained in the preamble to the proposed reliance regs that one of the general purposes of Code Sec. 1411 that it tries to fulfill through the proposed reliance regs is "to impose a tax on unearned income or investments of certain individuals, estates, and trusts." Despite the simplicity of this mission statement, defining net investment income in the proposed reliance regs requires the lion's share of the 159 pages of the just-released preamble and regs.*

Code Sec. 1411(c)(1) defines net investment income as the sum of:

- (i) *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);
- (ii) *Category (ii) income:* Other gross income derived from a trade or business described in Code Sec. 1411(c)(2); and
- (iii) *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.

Sec. 1411(c)(2) trade or business categories for net investment income. Code Sec. 1411(c)(2) describes two categories of trades and businesses to which the NII surtax applies:

- Any 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.

COMMENT: *Thus, interest, dividends, etc. are not net investment income if they are derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer and that is not trading of financial instru-*

ments or commodities. The IRS refers to this as the "ordinary course of a trade or business exception."

COMMENT: *If items of net investment income (including properly allocable deductions) pass through a partnership or S corp, the passthrough entity must separately state the items on Schedule K-1s issued to investors, a potentially burdensome requirement.*

Use of other Tax Code provisions. Despite its declaration of independence from being forced to apply other Tax Code principles to addressing Code Sec. 1411 issues, the IRS does give blanket approval in its preamble to the proposed reliance regs to the operation of certain Tax Code provisions side-by-side with Code Sec. 1411. Therefore, except as otherwise provided in the proposed reliance regs, the following Tax Code chapter 1 principles apply:

Gain that is not recognized under chapter 1 for a tax year is not recognized for that year for purposes of section 1411, including:

- Installment sales gain under Code Sec. 453;
- Deferred gain on like-kind exchanges under Code Sec. 1031;
- Deferred gain in involuntary conversion under Code Sec. 1033; and
- Gain on the sale of a principal residence excluded under Code Sec. 121

Deferral or disallowance provisions of chapter 1 that the proposed reliance regs interpret as applying to a determination of NII include:

- Limitation on investment interest under Code Sec. 163(d);
- Limitation of expense and interest relating to tax-exempt income under Code Sec. 265;
- At risk limitations under Code Sec. 465(a)(2);
- Passive activity loss limitations under Code Sec. 469(b);
- Partner loss limitations under Code Sec. 704(d);
- Capital loss carryover limitations under Code Sec. 1212(b); and
- S corp shareholder loss limitations under Code Sec. 1366(d)(2).

Further, carryover deductions in connection with these deferral or disallowance provisions otherwise allowed in determining adjusted gross income (AGI) are also allowed in determining NII.

IMPACT: *One concern receiving attention in the popular press lately has been the application of the 3.8 percent NII surtax to profits on the sale of a residence. The proposed reliance regs confirm that gain that is otherwise subject to income tax on the sale of a principle residence is also subject to classification as NII. However, through examples, the IRS reminds taxpayers that: first, gain is taxed only over and above the home sale exclusion permitted under Code Sec. 121 (generally, $500,000 of gain for joint filers and $250,000 of gain for most others); and second, the applicable threshold amount for being subject to the NII surtax must be exceeded. The taxable gain over and above the Code Sec. 121 exclusion, however, does contribute to the amount of modified adjusted gross income used to determine the threshold amount.*

Exceptions to general Tax Code principles. "To prevent circumvention of the purposes of the statute," the proposed reliance regs modify the Chapter 1 rules in certain cases. Examples include treating substitute interest and dividends as investment income even though not technically considered dividends or interest under Chapter 1; and treating under Code Sections 959(d), 1293(c), or 1291 as net investment income. Also carved out from general Chapter 1 treatment is the definition of adjusted gross income as it relates to investments in controlled foreign corporations and passive foreign investment companies.

Category (i) Income

Category (i) income (as described in Code Sec. 1411(c)(1)(i) within the three-part enumerated definition of net investment income) includes 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" (that is, from such interest, dividends, etc., not otherwise captured as NII under Code Sec. 1411(c)(2), which is explained, below, in "Category (ii) income")

Interest and dividends. The IRS elaborated in the preamble to the proposed reliance regs on the definition of interest, dividends, annuities, royalties, and rents. Interest and dividends includes any items treated as interest or dividends under chapter 1 (Code Secs. 1-1400). Dividends include corporate dividends (and constructive dividends), as well as amounts treated as dividends under other provisions of the Code and regs, for example, Sec. 1248 (gain from the sale of certain foreign corporations). The IRS clarified that net investment income also

MAGI THRESHOLDS FOR NET INVESTMENT INCOME SURTAX AFTER DECEMBER 31, 2012*

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

Note: The income thresholds are not indexed for inflation.
**from irs.gov, Net Investment Income Tax FAQs*

includes distributions from previously taxed earnings and profits.

IMPACT: *By far, the most common items of NII for most individuals will be the interest earned on bank accounts and the dividends realized on stock investments paid through brokerage accounts. Net capital gains, another common item of NII for a significant number of taxpayers, is a category (ii) item. Discussed below.*

IMPACT: *Corporate dividends paid in 2013 out of 2012 earnings and profits, for example, will not escape being classified as NII subject to NII tax in 2013. Making dividend distributions before 2012 year-end is an immediate strategy that should be considered, especially in expectation that the Bush-era tax cuts will expire for higher income individuals after 2012.*

COMMENT: *Substitute interest and dividends paid in a securities-lending transaction or sale-repurchase transaction are treated as interest and dividends and, therefore, as net investment income. The IRS explained this treatment is necessary to prevent taxpayers from avoiding the tax by lending their securities over a payment date.*

Annuities. Gross income from annuities includes a variety of payments made under an annuity, endowment or life insurance contract that are includible in gross income under Code Sections 72(a), 72(b), or 72(e). While the Tax Code does not define the term "annuity," the proposed reliance regs rely on the treatment of payments under Code Sec. 72. The IRS explained in the preamble to the proposed reliance regs that gain from the sale of an annuity contract is treated as income from an annuity if the sales price does not exceed the annuity's surrender value.

COMMENT: *The gain from the excess of the sales price over the surrender value of an annuity is treated as gain from the disposition of property, under the third category (category (iii)) of net investment income.*

Royalties and rents. Royalties include amounts received from mineral, oil and gas royalties. Payments for the use of patents, copyrights, goodwill, trademarks, franchises, and similar property are also treated as royalties. Rents include amounts paid for the use of (or right to use) tangible property.

Trade or business exception to category (i) income. Interest, dividends, etc., are not included in net investment income if they meet the ordinary course of a trade or business exception. This exception is determined under a two-part test:

> "At the heart of the NII surtax proposed reliance regs are efforts by the IRS to more precisely define 'net investment income' subject to the 3.8 percent tax."

- First, the item must be "derived in" a trade or business not described in section 1411(c)(2);and
- Second, if the item is derived in a trade or business not described in section 1411(c)(2), then such item must also be derived in the "ordinary course" of the trade or business.

Derived in. To determine whether the trade-or-business exception to category (i) income applies, it is first necessary to determine whether the item is derived in a trade or business described in Code Sec. 1411(c)(2). For a sole proprietor and a disregarded entity, this determination is made at the individual level. For an individual, estate, or trust (the taxpayer) that owns an interest in a trade or business through a passthrough entity (a partnership or S corporation), this determination is made as follows:

- Whether the trade or business is a passive activity with respect to the taxpayer is determined at the taxpayer level, in accordance with Code Sec. 469 (passive activity loss rules);
- Whether the trade or business involves trading in financial instruments or commodities at the passthrough entity level. If the entity is involved in this business, the income retains its character when passing through to the taxpayer (Prop. Reg. §1.1411-4(b)(2)).

The IRS reiterated in the preamble to the proposed reliance regs that if the passthrough entity is not engaged in any trade or business, its income will not qualify for the trade or business exception, even if the individual or an intervening entity is engaged in a trade or business. The individual's status under Code Sec. 469 (active or passive participant) is irrelevant if the passthrough entity is not engaged in a trade or business.

EXAMPLE: *Allen is engaged in a trade or business that is not described in Code Sec. 1411(c)(2) and the trade or business has gross income (royalties) Such gross income is derived in Allen's trade or business, and therefore Allen meets the first part of the ordinary course of a trade or business exception to category (i) NII tax. However, if Allen's trade or business is a passive activity with respect to Allen or if Allen's trade or business is trading in financial instruments or commodities, the ordinary course of a trade or business exception would be inapplicable because the income is derived in a trade or business described in Code Sec. 1411(c)(2) and is therefore NII under that latter category.*

Ordinary course. The proposed reliance regs do not provide guidance on the meaning of "ordinary course." The IRS instructed that taxpayers should rely on case law and other sections of the regs that address this issue, such as *Lilly, 343 U.S. 90 (Sup.Ct. 1953)*, and Reg. §1.469-2T(c)(3)(ii) (providing rules for determining whether certain portfolio income is excluded from the definition of passive activity gross income).

Wages. Wages and other compensation are not subject to the NII surtax. The IRS explained in the preamble to the proposed

reliance regs that amounts paid by an employer to an employee as wages subject to income tax withholding are not NII, because they are derived in the ordinary course of a trade or business of being an employee. In this manner, they qualify for the trade or business exception.

COMMENT: *The IRS clarified in the preamble to the proposed reliance regs that nonqualified deferred compensation paid to an employee under Code Sections 409A, 457(f), 457A, or other provisions, is not NII. However, because portfolio income (such as interest or dividends) under Code Sec. 469 is not considered derived in the ordinary course of a trade or business, it is net investment income under Category (i).*

Category (ii) Income

Category (ii) income (as described in Code Sec. 1411(c)(1)(ii) within the enumerated definition of net investment income) consists of "other gross income" from a trade or business in one of the categories for net investment income (passive income or trading in financial instruments or commodities). For a passive activity, other gross income generally includes gross income that is not interest, dividends, etc., described in Category (i), and that is not net gain from the disposition of property.

EXAMPLE: *Beth owns an interest in a partnership that runs a cattle ranching business. The business is a trade or business under Code Sec. 162. Beth does not materially participate in the business; thus, the partnership is a passive activity with respect to Beth, as described in Code Sec. 1411(c)(2)(A). The business generates net income from the sale of beef, and a portion of the income is allocated to Beth. Beth's income from the cattle ranch is other gross income derived from a trade or business described in Code Sec. 1411(c)(2).*

For the trading of financial instruments or commodities, other gross income will include gain from property held in the trade or business (rather than Category (iii) net gains). Other gross income also includes mark-to-market gain under Code Sec. 475(f).

NET INVESTMENT INCOME

Over 100 pages within the proposed reliance regulations (Prop. Reg. §1.1411) and preamble (NPRM REG-130507-11) 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).

Category (iii) Income

Category (iii) income (as described in Code Sec. 1411(c)(1)(iii) within the enumerated definition of net investment income) consists of taxable net gain from the disposition of property, other than property held in the passive/financial instruments trade or business categories. A disposition includes the sale, exchange, transfer, conversion, settlement, cancellation, termination, lapse or expiration of property. The rules of Chapter 1 determine whether there has been a disposition under Code Sec. 1411. Thus, a disposition includes a distribution of money from a partnership to a partner that exceeds the partner's basis.

IMPACT: *Net capital gains from investment accounts are perhaps the most common category (iii) type of income. In that regard, it is important to note that short-term or long-term gains are subject to the same 3.8 percent surtax, irrespective of the ordinary income rate applied to short-term gains or the lower rate applied to long-term capital gain.*

EXAMPLE: *Dylan, an unmarried individual, rents a boat to Bailey for $100,000 in what is a passive activity under Code Sec. 469(c). In the next year (2013), Dylan sells the boat to Bailey, recognizing a gain of $500,000 on the sale. Since the boat was not considered held in a trade or business not described in Code Sec. 1411(c)(2) because it was a trade or business that was a passive activity with respect to Dylan, the gain will be subject to NII surtax under category (iii).*

COMMENT: *The IRS explained in the preamble to the proposed reliance regs that capital gain dividends from mutual funds and real estate investment trusts are net gain under Category (iii), not dividend income under Category (i). Gain or loss from a nontrader who marks to market assets under Code Sec. 1256 is net investment income.*

COMMENT: *The gain and loss rules under Chapter 1 determine net gains under Category (iii). For example, if gain is not recognized under Code Sec. 1031 on a like-kind exchange, it is not recognized as net investment income.*

Losses may also be taken into account in determining net gain. This would apply to losses deductible under Code Sec. 165 if the property is not held in a trade or business, or if the property is held in a trade or business category related to net investment income. Capital losses that exceed capital gains are not recognized for Code Sec. 1411, but the $3,000 of losses allowable to noncorporate taxpayers may offset gains from the disposition of noncapital assets.

Exception. Category (iii) NII generally applies if the property disposed of is not held in a trade or business, or is held in a trade or business described in the one of the categories for net investment income (a passive activity; trading in financial instruments or commodities). Category (iii) does not apply to property held in a trade or business that is not described in the categories for net investment income (Prop. Reg. §1.1411-4(d)(3)(ii)(A)).

Whether property is "held" in a trade or business is determined in the same manner as whether gross income is "derived in" a trade or business. For sole proprietors and disregarded entities, this determination is made at the individual level. For taxpayers holding a passthrough interest, determining whether the trade or business is passive is also made at the individual level, while determining whether the trade or business is trading in financial instruments or commodities is determined at the entity level (Prop. Reg. §1.1411-4(d)(3)(ii)(B).

EXCEPTION FOR QUALIFIED PLAN DISTRIBUTIONS

Under Code Sec. 1411(c)(5), NII does not include any distribution from a plan or arrangement described in Code Sections 401(a), 403(a), 403(b), 408, 408A, or 457(b). The proposed reliance regs explain that distributions from qualified plans would encompass:

- A qualified pension, stock bonus, or profit sharing plan;
- A qualified annuity plan;
- A tax-sheltered annuity plan;;
- An individual retirement account (IRA)
- A Roth IRA; or
- A Section 457(b) plan of a state, local government, or tax-exempt organization.

The proposed reliance regs confirm that most transfers from one of these plans will qualify as an exempt distribution. Actual distributions, deemed distributions, rollovers and corrective distributions, permitted distributions to purchase life insurance or similar arrangement are all exempt from NII surtax (Prop. Reg. §1.1411-8(b)).

CAUTION: *The IRS reminded taxpayers in the preamble to the proposed reliance regs that distributions that may be excluded from NII may be included in gross income under the regular chapter 1 rules of the Tax Code and, therefore, would be taken into account in determining MAGI for purposes of calculating the amount of NII subject to NII surtax.*

EXCEPTION FOR ITEMS SUBJECT TO SELF-EMPLOYMENT TAX

The proposed reliance regs follow the lead of Code Sec. 1411(c)(6) in excluding from NII any item taken into account in determining self-employment income under Code Sec. 1401(b). The proposed reliance regs clarify that "taken into account" means income included and deductions allowed in determining net earnings from self-employment. A special rule for traders in financial instruments and commodities specifies that certain deductions in excess of those used to reduce self-employment income are allowed in determining NII (Prop Reg. §1.1411-9(b)).

CFCs AND PFICs

The proposed reliance regs provide special rules for controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs) (Prop. Reg. §1.1411-10). Dividends and gains from the stock of a CFC (as defined in Code Sec. 957(a)) or of a PFIC (as defined in Code Sec. 1297(a)) are included in computing net investment income. The rules apply to an individual, estate or trust that is a U.S. shareholder of a CFC, or that is a U.S. person that directly or indirectly owns an interest in a qualified electing fund (which involves an election made with respect to a PFIC).

IMPACT: *Inclusions to a U.S. shareholder under the CFC rules are not dividends unless expressly provided in the Tax Code. Similarly, inclusions to a U.S. person owning shares in a PFIC are not dividends. As a result, these amounts are not net investment income unless the amounts are derived from a trade or business to which the tax applies (Category (ii) income) (Prop. Reg. §1.1411-10(b)).*

Previously taxed income. Under the income tax rules, distributions of previously taxed earnings and profits are not included in income when there is an actual distribu-

tion from the foreign corporation. However, the proposed regulations treat actual distributions of earnings and profits (even if previously taxed under Chapter 1) as dividends that are includible in net investment income under Code Sec. 1411(c)(1)(A)(i) (Prop. Reg. §1.1411-10(c)(2)). Furthermore, any gain from the disposition of stock in a CFC or PFIC will give rise to Category (iii) net investment income (net gain from the disposition of property).

The rules on previously taxed income require basis adjustments to the stock of the CFC or PFIC. These adjustments would be calculated differently under the income tax and net investment income provisions, the IRS explained in the preamble.

COMMENT: *To minimize complexity from this different treatment, the proposed reliance regs provide an election that should result in consistent treatment for both purposes (Prop. Reg. §1.1411-10(g)). The reliance regs permit an election for a tax year that begins before January 1, 2014, as well as specifying that the election, if made, must be made for the first tax year beginning after December 31, 2013, during which applicable CFC or qualified electing fund holdings exist. Once made, the election is irrevocable to all future years, subject to IRS discretion.*

PROPERLY ALLOCABLE DEDUCTIONS

In determining net investment income under Code Sec. 1411(c)(1), the three categories of income items (referred to as gross income or net gain) are reduced by deductions that are properly allocable to the income. Only amounts paid or incurred to "produce" the income may be deducted.

NII may not be less than zero. If a deduction is not entirely used in the current year, the balance can only be carried over to another year if the underlying code section allows it, such as a suspended passive activity loss allowed in a later year under Code Sec. 469(b) (Prop. Reg. §1.1411-4(f)(1)(ii)).

IMPACT: *Under Code Sec. 469(g)(1), suspended passive losses may be deducted in the year that the taxpayer disposes of its interest in the passive activity. The IRS requested comments on how to treat these losses under Code Sec. 1411.*

Under the proposed reliance regs, a net operating loss (NOL) deduction cannot reduce net investment income, because the items comprising the NOL are not tracked, once included in the NOL, and the overall NOL itself is not "properly allocable" to any specific item of income (Reg. §1.1411-4(f)(1)(ii)).

EXAMPLE: *Anna, an unmarried individual, has an NOL of $20,000 in Year One. In Year Two, Anna has $200,000 of wages, $100,000 from trading in financial instruments or commodities, and $10,000 in trading activity expense deductions. Anna's $20,000 NOL is allowed in Year Two as an income tax deduction and as a deduction in computing modified adjusted gross income under Code Sec. 1411(a)(1)(B). However, the $20,000 NOL is not allowed in computing Anna's NII; thus, Anna's NII is $90,000 (the net income from the trading activity).*

Allowable ("properly allocable") deductions include the following:

- Rents and royalties – deductions described in Code Sec. 62(a)(4), such as depletion (Prop. Reg. §1.1411-4(f)(2));
- Interest income – penalties described in Code Sec. 62(a)(9) for penalties upon early withdrawals of savings;
- Trade or business deductions described in Code Sec. 62(a)(1);
- Certain itemized deductions, such as investment interest, investment expenses, and taxes (Prop. Reg. §1.1411-4(f)(3)(i)); and
- Miscellaneous itemized deductions, but only after application of the 2-percent floor and the overall deduction limit under Code Sec. 68 (Prop. Reg. §1.1411-4(f)(3)(ii)).

EXAMPLE: *Barbara, an unmarried individual, pays $4,000 of interest on debt incurred to purchase stock. Barbara has $5,000 of investment income, and has $10,000 of income from a trade or business that is a passive activity. The interest expense is deductible against the investment income for income tax purposes under Code Sec. 163(d). The interest expense may be deducted in determining Barbara's Code Sec. 1411 NII.*

Losses under Code Sec. 165 are deductible only in computing net gain (Category (iii) income from the disposition of property), and only to the extent of gains, so they are not properly allocable deductions (Prop. Reg. §1.1411-4(f)(4)). The IRS notes that "net gain" cannot be less than zero and that any excess losses are not allowed in computing net investment income.

SECTION 1411 TRADES OR BUSINESSES

Code Sec. 1411(c)(1)(A) defines the items that comprise NII: (i) gross income from interest, dividends, royalties, etc., unless derived in the ordinary course of a trade or business to which the NII surtax does not apply; (ii) other gross income derived from a trade or business to which the NII surtax applies; and (iii) net gain from the disposition of property other than property in a trade or business to which the NII tax does not apply.

The trade or business described under Code Sec. 1411(c)(2) to which the NII surtax applies consists of:

- A trade or business that is a passive activity with respect to the taxpayer under Code Sec. 469 (Code Sec. 1411(c)(2)(A)); and
- A trade or business of trading in financial instruments or commodities (Code Sec. 1411(c)(2)(B)).

To define a trade or business, the preamble to the proposed reliance regs refers to Code Sec. 162, which permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on "a trade or business." The proposed reliance regs incorporate the rules under Code Sec. 162, includ-

NET INVESTMENT INCOME SURTAX PROPOSED RELIANCE REGS – TOPICS ADDRESSED

The proposed reliance regulations on the 3.8 percent net investment income tax are proposed to be effective January 1, 2014, but may be relied on immediately by taxpayers until final regulations are released. They are organized under the following headings:

§1.469-11. Effective date and transition rules ((iv) Regrouping for taxpayers subject to section 1411)

§1.1411-1 General rules.

§1.1411-2 Application to individuals.

§1.1411-3 Application to estates and trusts.

§1.1411-4 Definition of net investment income.

§1.1411-5 Trades and businesses to which tax applies.

§1.1411-6 Income on investment of working capital subject to tax.

§1.1411-7 Exception for dispositions of interests in partnerships and S corporations.

§1.1411-8 Exception for distributions from qualified plans.

§1.1411-9 Exception for self-employment income.

§1.1411-10 Controlled foreign corporations and passive foreign investment companies.

ing the large body of law and administrative guidance that has developed.

COMMENT: *The IRS predicted in the preamble to the proposed regs that use of the Code Sec. 162 definition of trade or business would simplify taxpayer compliance.*

Passive activities. Code Sec. 1411 is intended to take into account gross income from, and net gain attributable to, a passive activity with respect to the taxpayer that involves the conduct of a trade or business. However, the IRS explained in the preamble to the proposed regs that the definition of trade or business and passive activity is more restrictive for Code Sec. 1411 purposes than under Code Sec. 469 in two respects:

- Code Sec. 469 includes any activity conducted in anticipation of the commencement of a trade or business, and any activity involving research or experimentation under Code Sec. 174; and
- While Code Sec. 469 defines passive activity as any trade or business in which the taxpayer does not materially participate, it also includes any rental activity in the definition of passive activity.

Application of existing Code Sec. 469 rules. Code Sec. 469 and its regs provide rules for determining whether trade or business activities and certain rental activities are passive activities with respect to a taxpayer. The IRS explained in the preamble to the proposed reliance regs that these rules will also apply in determining whether a Code Sec. 162 trade or business is a passive activity for purposes of Code Sec. 1411(c)(2)(A). Within this scope are:

- The material participation requirements of Code Sec. 469(h)(1) and Reg. §1.469-5T;
- The rules treating the rental real estate activities of real estate professionals as an active trade or business if the taxpayer materially participates, provided the rental real estate activities are a trade or business under Code Sec. 162;
- The rules and exceptions that treat rental activities as being (or not being) a *per se* passive activity. However, if the rental activity is not a trade or business under Code Sec. 162, the income will be NII; and
- The grouping rules for determining the scope of a taxpayer's trade or business and whether the activity is a passive activity; provided that a grouping of rental activities with another trade or business will not convert rental income into other gross income that avoids the NII surtax.

Fresh start regrouping. Ordinarily, a taxpayer that groups activities cannot regroup the activities in subsequent years. Significantly, because of the enactment of Code Sec. 1411, the IRS will allow taxpayers a "fresh start" where they may regroup their activities in tax years beginning in 2013. The regrouping must comply with the disclosure and reporting requirements of Reg. §1.469-4(e) and Rev. Proc. 2010-13.

IMPACT: *A regrouping election had been on the short list of relief measures requested by many practitioners and taxpayers. Regrouping to indicate material participation can assist in avoiding the NII surtax although may change the dynamics for netting passive losses and income. A taxpayer may only regroup activities once and any such regrouping will apply to the tax year for which the regrouping is done and all subsequent years. The proposed reliance regs provide no specific deadline for regrouping; nor do they indicate whether a regrouping made now would be allowed*

to be changed again when the regs are made final.

COMMENT: *Rev. Proc. 2010-13 generally requires taxpayers to report their groupings and regroupings of activities and the addition of specific activities within their existing groupings of activities for purposes of Code Sec. 469 and its regs.*

Rental activity. The IRS, in an example in the proposed reliance regs, explains what has been an elusive application of interrelated principles to rental activity (Prop. Reg. §1.1411-5(b)(2), Ex 1).

EXAMPLE: *Abby, an unmarried individual, rents a commercial building to Brandon for $50,000 in Year 1. Abby's rental activity does not involve the conduct of a Code Sec. 162 trade or business, but under Code Sec. 469(c)(2), Abby's rental activity is a passive activity. However, since the rental activity is not considered a trade or business within the meaning of Code Sec. 162, Abby's rental income of $50,000 is not derived from a trade or business to which the NII tax applies. However, Abby's rental income of $50,000 will still constitute gross income from rents under Category (i) [gross income from interest, dividends, annuities, royalties, rents, substitute interest payments, and substitute dividend payments, except to the extent excluded by the ordinary course of a trade or business exception] because Category (i) does not require a trade or business (Prop. Reg. §1.1411-4(a)(1)(i)).*

Passive income restrictions. Code Sec. 469 restricts taxpayers from artificially generating passive income from certain passive activities. These rules interact with the Code Sec. 1411 requirements.

Portfolio income. Interest, dividends, etc. that are not derived in the ordinary course of a trade or business are treated as portfolio income under Code Sec. 469 and are not used to determine whether there is income or loss from an activity. Therefore, the items in Category (i) of NII will be included in Code Sec. 1411, because portfolio items are not derived in the ordinary course of a trade or business.

COMMENT: *There are special rules under Code Sec. 469 for working capital, for recharacterizing net income, and for substantially appreciated property. These items, discussed elsewhere in the proposed reliance regs, generally will be subject to Code Sec. 1411 (see Working Capital discussion, below).*

> "Because of the enactment of Code Sec. 1411, the IRS will allow taxpayers a 'fresh start' where they may regroup their passive activities in tax years beginning in 2013."

The activity of trading personal property (as specifically defined in Code Sec. 1092(d)), for the account of owners of interests in the activity, is not a passive activity under Code Sec. 469. Although the income is not from a passive activity, it may be subject to the NII surtax under Code Sec. 1411 if the activity is a trade or business of trading in financial instruments or commodities, as described in Code Sec. 1411(c)(2)(B).

COMMENT: *Code Sec. 1092 concerns straddles and other financial instruments.*

Trading in financial instruments or commodities. It is necessary to distinguish among dealers, traders, and investors to determine whether trading in financial instruments (or commodities) is a trade or business under Code Sec. 162. The proposed reliance regs do not change the state of the law with respect to the classification of dealers, traders or investors.

A dealer in securities purchases from customers or sells to customers, or regularly offers to enter into positions with customers, and is involved in a trade or business. A trader seeks profit from market swings and will be engaged in a trade or business if the trading is frequent and substantial. An investor seeks income from interest, dividends and long-term appreciation. A person who qualifies as a trader may be engaged in a trade or business for Code Sec. 1411(c)(2)(B).

COMMENT: *The IRS reiterated in the preamble to the proposed reliance regs that management of one's own investments is not considered a Code Sec. 162 trade or business no matter how extensive or substantial the investments might be. Nevertheless, income from personal investment management is typically category (i) income subject as such to the NII surtax.*

The proposed reliance regs borrow the definition of financial instruments in Code Sec. 731. A financial instrument includes stock and other equity interests, debt, options, forwards or futures, notional principal contracts, other derivatives, and interests in any of these items, including short positions and partial units (Prop. Reg. §1.1411-5(c)). "Commodities" has the same meaning as in Code Sec. 475(e)(2).

WORKING CAPITAL EXCEPTION

Trade or business income does not include income earned from the investment of working capital. The IRS acknowledged in the preamble to the proposed reliance regs that neither Code Sec. 469 nor Code Sec. 1411 define "working capital." According to the IRS, the term generally refers to capital set aside for use in, and for the future needs of, a trade or business. Working capital may be invested in income producing liquid assets, such as savings accounts, certificates of deposit, money market accounts, short-term bonds, and similar investments.

IMPACT: *NII surtax on working capital can pose an unexpected liability for a business conducted by a sole proprietor,*

partnership, or S corp, which otherwise escapes the NII surtax. Any income from the investment of working capital is subject to the NII surtax based upon the proposed reliance regs (Prop. Reg. §1.1411-6). Cash-intensive businesses using interest-bearing accounts, as well as businesses that park some extra funds until a project begins, should be alert to this "hidden" NII surtax in connection with an active business operation.

EXAMPLE: *Adam is the sole owner/operator of a restaurant that does business as an S corp and maintains an interest-bearing checking account with an average daily balance of $2,500 to hold cash receipts and pay ordinary and necessary business expenses. The S corp also has set aside an additional $20,000 for the potential future needs of the business. Both the checking account and $20,000 are considered working capital, with interest earned on them subject to NII surtax imposed on Adam, who is allocated the interest through the S corp (Prop. Reg. §1.1411-6(b)).*

COMMENT: *The preamble to the proposed reliance regs refers to working capital as capital that "may not be necessary for the immediate conduct of the trade or business." But the above example in the proposed reliance regs appears to demonstrate that the government will not enter into the task of trying to determine whether capital is "necessary for the immediate conduct of the business."*

COMMENT: *For purposes of the NII surtax on working capital investment income, Code Sec. 1411(c)(3) directs the IRS to apply a rule similar to Code Sec. 469(e)(1)(B) of the passive activity loss rules. Under Code Sec. 469(e)(1)(B), portfolio-type income, such as interest, that is generated by working capital is not derived in the ordinary course of a trade or business, cannot be characterized as passive income, and therefore cannot offset a taxpayer's passive losses.*

Allocable deductions. In determining NII, the IRS explained in the preamble to the proposed reliance regs that a taxpayer may take into account allocable deductions related to losses or deductions from the investment of working capital. Prop. Reg. §1.1411-4(f) describes properly allocable deductions, such as investment expenses or investment interest expenses, but does not specifically discuss expenses from investing working capital.

EXCEPTION FOR DISPOSITION OF PARTNERSHIPS/ S CORP INTERESTS

Generally, an interest in a partnership or S corp (a "passthrough" interest) is not considered property held in a trade or business (although the underlying business itself may be). Therefore, gain or loss from the sale of a passthrough interest would be included in NII under Category (iii).

Exception. Despite this general rule, the amount of gain (or loss) on the disposition of a passthrough interest that is included in NII under Category (iii) is limited to the net gain (or loss) that would be taken into account *if* the partnership or S corp sold all of its assets at fair market value immediately before the disposition of the interest (a deemed sale) (Code Sec. 1411(c)(4); Prop. Reg. §1.1411-7(a)).

IMPACT: *The IRS explained in the preamble to the proposed reliance regs that Congress intended to put the transferor of a passthrough interest in a similar position as if the partnership or S corp had disposed of all of its properties and then passed its gain or loss through to its owners (including the transferor).*

Use of property. To achieve parity between the sale of a passthrough interest and the sale of the entity's assets, the proposed reliance regs apply Code Sec. 1411(c)(4) on a property-by-property basis (Prop. Reg. §1.1411-4(d)(3)). This is because the Code Sec. 1411(c)(4) exception applies only where the property is held in a trade or business that is *not* a passive activity or trading business described in Code Sec. 1411(c)(2). Thus, it must be determined whether each of the entity's deemed-sold properties was used in a trade or business that qualifies for the exception.

IMPACT: *According to the preamble to the proposed reliance regs, this means that the exception does not apply where (1) there is no trade or business; (2) the trade or business is a passive activity (within the meaning of Prop Reg §1.1411-5(a)(1)) with respect to the transferor of the interest; or (3) the partnership or S corp is in the trade or business of trading in financial instruments or commodities (within the meaning of Prop Reg §1.1411-5(a)(2)). The exception, the IRS explained, would not apply because there would be no change in the category (iii) amount of net gain determined upon the asset sale.*

Underlying properties. The transferor of the interest computes gain or loss from the sale of the underlying properties using a deemed asset sale method, and then determines if there is an adjustment to the gain or loss from the disposition of the passthrough interest.

If there is a gain on the sale of the interest, and some of the underlying property is not described in Code Sec. 1411(c)(2), a negative adjustment that reduces gain from the sale of the interest may be required. In this case, the Code Sec. 1411(c)(4) exception would apply, NII would be reduced, and there would be less NII surtax due.

IMPACT: *The proposed reliance regs on deemed sales apply partnership basis adjustment rules under Code Sec. 743. The IRS explained in the preamble to the proposed reliance regs that this approach could impose a burden on owners of the passthrough interests, and requested comments on other methods that would be less burdensome.*

Deemed asset sale method. Use of the deemed asset sale method (Deemed Sale) in the proposed reliance regs is a multi-step ap-

proach to determining whether the exception for dispositions of partnership/S corp interests applies.

- The first step is a hypothetical disposition of all the entity's properties, including goodwill, for cash in a fully taxable transaction at fair market value (FMV) of the entity's properties immediately before disposition of the interest.
- The second step is a separate computation of gain or loss on each of the entity's properties (including goodwill), determined by comparing the FMV of each property with its adjusted basis.
- The third step is the allocation of the gain or loss from each property to the transferor, taking into account the partnership agreement or relevant S corp provisions.
- The fourth step is the determination of whether the gain or loss allocated to the transferor for each property would have been taken into account under category (iii).

Thus, if a property is either held in a trade or business described in section 1411(c)(2) or is not held in a trade or business, there will be no adjustment of the transferor's gain (or loss) taken into account as NII. For properties that do not fall into these categories, there is an adjustment under section 1411(c)(4) calculated in the following manner: the gains and losses from the properties are aggregated, with a net gain creating a negative adjustment, and a net loss creating a positive adjustment (Prop. Reg. §1.1411-7(c)).

IMPACT: *The IRS pointed out in the preamble of the proposed reliance regs that if, for example, the transferor has a gain of $100,000 on the disposition of the interest, the Code Sec. 1411(c)(4) adjustment cannot be greater than $100,000, and cannot result in a loss.*

Special situations. The proposed reliance regs provide special rules for various situations (Prop. Reg. §1.1411-7):

- If property was held in more than one trade or business in the previous 12 months, the gain must be allocated among the trades or businesses on a basis that reasonably reflects the use of the property.
- Special rules determine the gain or loss from goodwill for purposes of the Code Sec. 1411(c)(4) exception. If the taxpayer disposed of S corp stock and made a Code Sec. 338(h)(10) election, the exception does not apply, because the sale of stock is treated as an actual asset sale by the S corp.
- If the taxpayer sells the passthrough interest in an installment sale, the adjustment to net gain is calculated in the year of the disposition, but the gain and any adjustment are deferred. If an installment sale attributable to a disposition of an interest in a partnership or S corp occurred before the effective date of Code Sec. 1411, taxpayers may elect into the proposed reliance regs.
- If a qualified subchapter S trust sells S corp stock, any gain or loss recognized on the sale will be that of the trust, not of the income beneficiary.

COMMENT: *Any transferor making a Code Sec. 1411(c)(4) adjustment must attach a statement to the transferor's return for the year of the disposition. The statement must include: (1) a description of the disposed-of interest; (2) the name and taxpayer identification number (TIN) of the entity disposed of; (3) the fair market value of each property of the entity; (4) the entity's adjusted basis in each property; (5) the transferor's allocable share of gain or loss with respect to each property; (6) information regarding whether the property was held in a trade or business not described in Code Sec. 1411(c)(2); (7) the amount of the Code Sec. 1411(c)(1)(A)(iii) gain on the disposition of the interest; and (8) the computation of the adjustment under Prop Reg §1.1411-7(c)(5) (Prop. Reg. §1.1411-7(d)).*

TAXPAYERS SUBJECT TO NII SURTAX

Individuals

The NII surtax applies to individuals, with the exception of nonresident aliens (Code Sec. 1411(a), (e)). The proposed reliance regs define "individual" in two ways:

(1) the NII surtax applies to any natural person, except for natural persons who are nonresident aliens; and
(2) the NII surtax applies to any citizen or resident of the United States (Prop. Reg. §1.1411-2(a)(1)).

Joint returns: U.S. citizen or resident married to nonresident alien. For purposes of applying the NII tax to U.S. citizens or residents married to nonresident aliens, the spouses generally must be treated as married filing separately. Under normal rules, the nonresident alien's investment income will be exempt from NII surtax while the U.S. citizen or resident alien will be subject to the lower $125,000 threshold amount and must determine his or her separate net investment income and modified adjusted gross income (MAGI) (Prop. Reg. §1.1411-2(a)(2)(i)). However, if these married taxpayers elect under Code Sec. 6013(g) to file jointly by treating the nonresident alien as a resident of the U.S., the proposed reliance regs would allow them to elect to be treated as making the same election for purposes of Code Sec. 1411. In that case, the threshold amount is $250,000 and all income is combined.

IMPACT: *Prop Reg. §1.1411-2(a)(2)(i)(B)(2) sets forth the procedural requirement for making such an election, which delegates certain specifics to be determined by the IRS. Consistent with the existing Code Sec. 6013(g) election, the deadline for the NII surtax election presumably will be when 2013 returns are filed in 2014.*

Bona fide residents of U.S. territories. The application of the NII surtax to a bona fide resident of a U.S. territory depends on whether the U.S. territory has a mirror code system of taxation (Prop. Reg. §1.1411-2(a)(2)(iv)). Residents of those territories that have a mirror system (Guam, the Northern Mariana Islands and the United States Virgin Islands) generally are not subject to the NII surtax. Bona fide residents of non-mirror code jurisdictions (American

Samoa and Puerto Rico) are subject to NII surtax if they have U.S. reportable income that gives rise to both NII and modified adjusted gross income exceeding the threshold amount. However, a different result may apply to bona fide residents who are nonresident alien individuals (Prop. Reg. §1.1411-2(a)(2)(iv)(B)).

Trusts And Estates

The 3.8 percent NII surtax is not just imposed on individuals. Under Code Sec. 1411(a)(2), trusts and estates are subject to the NII surtax on the *lesser* of:

- undistributed net investment income, *or*
- the excess of adjusted gross income over the dollar amount at which the highest tax bracket begins (which, for 2013, is projected to be $11,950).

IMPACT: *Unlike the threshold amounts for individuals, the amount used for trusts and estates to compute NII will be adjusted for inflation because it is pegged to the highest bracket amount under Code Sec. 1(e) each year. Nevertheless, that amount is far less than the lowest threshold amount for individuals ($125,000 for married individuals filing separately). Trusts and estates should consider distributing investment income, especially if one or more beneficiaries will not otherwise be subject to NII surtax because of their threshold amount. 2012 year-end acceleration of income (a deferral of deductions) and distribution to beneficiaries can serve to avoid the 3.8 percent NII surtax on either the trust/estate or beneficiary level.*

COMMENT: *Portions of the proposed reliance regs are relatively complex in accomplishing what is generally a straightforward result: either the trust and estate or its beneficiaries, but not both, may be subject to NII surtax on any given item of net income. NII distributed from a trust or estate (or, in the case of a grantor trust, a deemed distribution) subjects the beneficiary to NII surtax, rather than the trust or estate itself.*

General approach. Congress failed to provide much detail under Code Sec. 1411 on application of the NII surtax specifically to trusts. In that absence, the IRS explained that its role is to fill in the details, which the proposed reliance regs generally accomplish.

In the preamble to the proposed reliance regs, the IRS explained that it is following through on what it understands to be Congress' intention to subject ordinary trusts and estates to Code Sec 1411. As a result, the proposed reliance regs adopt the general rule that Code Sec. 1411 applies to all estates and trusts subject to part 1 of subchapter J of chapter 1 of subtitle A of the Code.

Because only trusts under the purview of Subchapter J are potentially subject to NII surtax, however, certain trusts are not subject to NII surtax at the entity level, namely business trusts, entities eligible under the entity classification rules in Reg §301.7701-3, and certain state law trusts. By the same measure, trusts such as pooled income funds, cemetery perpetual care funds, qualified funeral trusts and certain Alaska Native settlement trusts are subject to NII surtax.

COMMENT: *While this last group of trusts (pooled income funds, etc.) is subject to NII surtax under the proposed regs, the IRS stated its willingness to consider comments addressing any administrative reason to exclude one or more of them from NII surtax.*

Tax-exempt trusts. The NII surtax does not apply to any trust, fund or special account exempt from tax under Code Sec. 501 or Sec. 664(c)(1). This exemption includes any unrelated business taxable income comprised of NII (Prop. Reg. §1.1411-3(b)).

The preamble to the proposed reliance regs also points to Code Sec. 1411(e)(2) as specifically exempting from NII surtax a trust in which all of the unexpired interests are devoted to one of more charitable purposes under Code Sec. 170(c)(2)(B) (organized for religious, charitable, scientific, etc. purposes).

Grantor trusts. A grantor trust is a trust (or any portion thereof) that is treated as being owned by the grantor or another person under Code Secs. 671 through 679. The proposed reliance regs carry forward this ownership-pass through tax treatment for NII surtax purposes. The NII surtax is not imposed on the grantor trust but rather on the grantor or other owner, with income, deductions and credits so allocated in calculating such grantor/owner's net investment income (Prop. Reg. §1.1411-3(b)(5)).

Electing small business trusts. The proposed reliance regs provide special NII computational rules for electing small business trusts (ESBTs) (Prop. Reg. §1.1411-3(c)(1)). Code Sec. 641(c)(1) provides that (1) the portion of any ESBT consisting of stock in one or more S corps must be treated as a separate trust and (2) the amount of tax imposed on such separate trust is determined under certain Code Sec. 641(c)(2) modifications. The proposed reliance regs preserve this treatment of the ESBT as two separate trusts for computational purposes. However, the proposed reliance regs consolidate the ESBT into a single trust for determining the NII adjusted gross income threshold bracket amount "so as to not inequitably benefit ESBTs over other taxable trusts."

The proposed reliance regs specify a three-step method for determining the ESBT's Code Sec. 1411 tax base:

(1) The ESBT separately calculates the undistributed net investment income of the S and non-S portion in accordance with general chapter 1 rules, and then combines those amounts;
(2) The ESBT determines AGI solely for NII tax purposes by adding the net income or loss from the S portion to that of the non-S portion as a single item of income or loss; and
(3) The ESBT compares the combined undistributed net investment income with the excess of its adjusted gross income over the section 1(e) threshold.

Charitable remainder trusts. Charitable remainder trusts (CRTs) are also subject

to special computational rules (Prop. Reg. §1.1411-3(c)(2)). Although a CRT itself is exempt from NII surtax, post-2012 distributions to non-charitable beneficiaries, as well as accumulated NII may be subject to NII surtax. The proposed reliance regs maintain the character and distribution ordering rules under existing Code Sec. 664 regs for purposes of the NII surtax. The IRS explained that these proposed CRT rules are designed to determine whether items of income allocated to annuity or unitrust payments are NII to the recipient beneficiary.

The proposed reliance regs provide that distributions from a CRT to a beneficiary for a tax year are NII in an amount equal to the *lesser* of:

(1) the total amount of the distributions for that year, *or*
(2) the current and accumulated net investment income for the CRT (Prop. Reg. §1.1411-3(c)(2)).

Accumulated net investment income for this purpose is the total amount of NII received by a CRT for all tax years beginning after December 31, 2012, less the total amount of net investment income distributed for all prior tax years beginning after December 31, 2012. Apportionment in the case of multiple beneficiaries is required.

IMPACT: *Prompt action by CRT trustees to accelerate NII into 2012 before year-end and defer expenses and losses into 2013 may help save 3.8 percent NII surtax that eventually would otherwise be imposed on CRT non-exempt beneficiaries.*

COMMENT: *The IRS had considered an alternate approach under which trustees would be required to account for and determine NII on a class-by-class basis within each category under Reg §1.664-1(d)(1). Although perhaps more consistent with statutory purpose, the IRS explained that it dropped this alternative in light of the recordkeeping and compliance burdens that would be imposed on trustees.*

Bankruptcy estates. A bankruptcy debtor under Chapter 7 or Chapter 11 of the Bankruptcy Code who is an individual may be subject to the NII surtax. In that case, the bankruptcy estate is subject to the same lower $125,000 threshold amount as a married taxpayer filing a separate return (Prop. Reg. §1.1411-2(a)(2)(iii)).

Foreign estates and trusts. Acknowledging that Code Sec. 1411 does not specifically address the treatment of foreign estates and foreign nongrantor trusts, the IRS stated in the preamble to the proposed reliance regs its intention to follow under the general principle that Code Sec. 1411 should not apply to foreign estates and foreign trusts that have little or no connection to the U.S. However, it also stated its intention as carried forward in the proposed reliance regs to tax NII of a foreign estate or foreign trust to the extent the income is earned or accumulated for the benefit of, or distributed to, U.S. persons. (Prop. Reg. §1.1411-3(c)(3)).

ADDITIONAL 0.9 PERCENT MEDICARE TAX

Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) program and Medicare's Hospital Insurance (HI) program are financed primarily by employment taxes. The Medicare tax equals 1.45 percent of covered wages. The employee-share of Medicare tax is exactly matched by the employer for calendar year 2012. For self-employed individuals, the basic rate of Medicare tax is the same as the combined employee and employer Medicare tax rates (2.9 percent).

Effective for tax years beginning after December 31, 2012, the Additional Medicare Tax increases the employee-share of Medicare tax by an additional 0.9 percent of covered wages in excess of certain "higher-income-level" threshold amounts (Prop. Reg. §31.3101-2(b)(2). Similarly, the Additional Medicare Tax increases Medicare tax on self-employment income for any tax year beginning after December 31, 2012 by an additional 0.9 percent of self-employment income in excess of certain threshold amounts (Prop. Reg. §1.1401-1(b)).

IMPACT: *Single individuals liable for Additional Medicare Tax after 2012 will pay 1.45 percent Medicare tax on the first $200,000 of compensation ($250,000 in the case of married couples filing a joint return and $125,000 in the case of married couples filing separate returns) plus 2.35 percent (1.45 percent + 0.9 percent) on compensation in excess of $200,000 ($250,000 in the case of married couples filing joint returns and $125,000 in the case of married couples filing separate returns). Unlike Social Security tax, there is no ceiling on the amount of compensation subject to Medicare tax.*

IMPACT: *There is no "employer match" for the Additional Medicare Tax. The 1.45 percent rate paid by employers remains unchanged after 2012. The Additional Medicare Tax also applies to Railroad Retirement Tax Act (RRTA) compensation.*

Threshold Amounts

The Additional Medicare Tax is not imposed until an individual's covered wages, compensation and/or self-employment income exceed the threshold amount for the taxpayer's filing status. The threshold amounts are: $200,000 for single individuals (and heads of household (with qualifying person) and qualifying widows (or widowers) with dependent child); $250,000 for married couples filing a joint return; and $125,000 for married individuals filing separate returns (Prop. Reg. §31.3101-2(b)(2)(ii); Prop. Reg. §1.1401-1(d)).

IMPACT: *The Additional Medicare Tax is imposed when covered wages, compensation and/or self-employment income exceed these threshold amounts ($200,000, $250,000 and $125,000, respectively). Employers, however, must withhold Additional Medicare Tax from wages paid to an individual in excess of $200,000 in a calendar year, without regard to the individual employee's filing status or other wages/compensation (Prop. Reg. §31.3102-4(a)).*

IMPACT: *The threshold amounts are <u>not</u> indexed for inflation. As a result, the pool*

of individuals captured by the Additional Medicare Tax will progressively increase over time unless a future Congress indexes the threshold amounts for inflation or adjusts the amounts higher.

COMMENT: *The threshold amounts are the same for wage earners and self-employed individuals. Taxpayers who anticipate they will owe Additional Medicare Tax, and who did not request additional income tax withholding, may need to make estimated tax payments; however, taxpayers cannot designate any estimated tax payments specifically for Additional Medicare Tax (Additional Medicare Tax FAQ 11; Additional Medicare Tax FAQ 12).*

COMMENT: *The threshold amounts mirror the dollar amounts proposed by President Obama in his fiscal cliff proposals, as well as the primary threshold levels used in computing the 3.8 percent Net Investment Income surtax. However, the Additional Medicare Tax thresholds only include wages, compensation and self-employment income rather than all income used to compute adjusted gross income.*

Covered Wages

Wages subject to income tax withholding and FICA (Social Security and Medicare) taxes are all considered payments received as compensation. All wages subject to Medicare tax are subject to the Additional Medicare Tax if the wages are paid in excess of the threshold amount for an individual's filing status. Wages for FICA (Social Security and Medicare) tax purposes generally include:

- Tips and gratuities
- Commissions that are part of compensation
- Bonuses
- Gifts by employers to employees
- Most awards and prizes
- Reimbursements of employee business expenses under nonaccountable plans
- Standby pay
- Back pay awards
- Dismissal pay
- Dividends recharacterized as compensation
- The cash value of all remuneration paid in any medium other than cash

IMPACT: *The preamble to the proposed reliance regs explains that calculating wages for purposes of withholding Additional Medicare Tax is generally no different than calculating wages for FICA (Social Security and Medicare).*

COMMENT: *The Sixth Circuit Court of Appeals recently found that supplemental unemployment benefit (SUB) payments were not wages for FICA purposes (In re Quality Stores, Inc., 2012-2 ustc ¶50,551). According to the Sixth Circuit, prior IRS rulings were inconsistent with the statute. The issue may need to be resolved by the U.S. Supreme Court.*

Nonqualified deferred compensation. The IRS explained in the preamble to the proposed reliance regs that if an employee has amounts deferred under a nonqualified deferred compensation plan, and the nonqualified deferred compensation is taken into account as wages for FICA (Social Security and Medicare) purposes under a special timing rule, the nonqualified deferred compensation would likewise be taken into account under the special timing rule to determine an the employer's obligation to withhold Additional Medicare Tax.

Tips. Tips, the IRS explained in its FAQs, are subject to Additional Medicare Tax if in combination with other covered wages/compensation they exceed the taxpayer's applicable threshold amount. Tips are subject to Additional Medicare Tax withholding if in combination with other wages paid by the employer exceed the $200,000 withholding threshold (Additional Medicare Tax FAQ 18).

Employer Withholding

An employer is required to collect Additional Medicare Tax with respect to wages earned for duties performed by the employee for the employer only to the extent the employer pays wages to the employee in excess of $200,000 in a calendar year (Prop. Reg. §31.3102-4). This rule applies without regard to the employee's filing status or other wages/compensation.

IMPACT: *The employer's obligation to withhold Additional Medicare Tax kicks-in at $200,000. This is distinct (as explained above) from the threshold amounts for liability for Additional Medicare Tax.*

IMPACT: *Employees may not request that their employer withhold Additional Medicare Tax on wages of $200,000 or less. Employees who expect to pay Additional Medicare Tax may request that their employer withhold an additional amount of income tax, which can offset any combined income and payroll tax shortfall, including*

COVERED INCOME THRESHOLDS FOR ADDITIONAL MEDICARE TAX AFTER DECEMBER 31, 2012*

Filing Status	Threshold Amount
Married couple filing joint return	$250,000
Married couple filing separate returns	$125,000
Single taxpayer	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$200,000

Note: The income thresholds are not indexed for inflation.
**from irs.gov, Q&As for the Additional Medicare Tax*

from the Additional Medicare Tax, that would otherwise require payment along with possible estimated tax penalties.

EXAMPLE: *Henry, who is married and files a joint return, receives $100,000 in wages from his employer for the calendar year. Ilana, Henry's spouse, receives $300,000 in wages from her employer for the same calendar year. Henry's wages are not in excess of $200,000 so Henry's employer is not obligated to withhold Additional Medicare Tax. Ilana's employer is obligated to collect Additional Medicare Tax with respect to wages it pays to Ilana in excess of the $200,000 threshold for the calendar year (Prop. Reg. §31.3102-4(a)).*

EXAMPLE: *Jacob, who is married and files a joint return, receives $190,000 in wages from his employer for the calendar year. Maria, Jacob's spouse, receives $150,000 in wages from her employer for the same calendar year. Neither Jacob nor Maria's wages are in excess of $200,000, so neither employer would be required to withhold Additional Medicare Tax. However, Jacob and Maria would be liable to pay Additional Medicare Tax on $90,000 ($340,000 minus the $250,000 threshold for a jointly filed return by a married couple) (Prop. Reg. §31.3102-4(b)).*

COMMENT: *Individuals who receive wages from more than one employer, and who expect those wages to exceed the threshold amounts, should consider increasing their withholding or making estimated tax payments.*

Pay period. An employer is obligated to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of $200,000 to an employee, the IRS explained in its FAQs (Additional Medicare Tax FAQ 28).

IMPACT: *Because an employer does not prorate any expected withholding liability in connection with any employee over the entire year, but only starts withholding in the paycheck in which the $200,000 level is exceeded, employers will not face this additional withholding obligation for many affected employees until well into 2013.*

COMMENT: *Employers are not required to notify employees when they begin withholding Additional Medicare Tax, the IRS explained in its FAQs (Additional Medicare Tax FAQ 25).*

Common paymaster. Amounts disbursed by a common paymaster are treated as paid by a single employer.

> "An employer is obligated to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of $200,000 to an employee."

Married employees. An employer may know that two of its employees are married and that their combined wages will exceed the threshold amount for married couples filing joint return. The IRS, in its FAQs, observed that employers should not combine the wages it pays to two employees to determine whether to withhold Additional Medicare Tax (Additional Medicare Tax FAQ 30).

Forms. The IRS reported that it intends to revise Form 941, Employer's Quarterly Federal Tax Return, to reflect Additional Medicare Tax. Form W-2, Wage and Tax Statement, however, will not be revised. Employers will report Additional Medicare Tax withholding along with regular Medicare tax withholding (Additional Medicare Tax FAQ 41).

COMMENT: *Box 6 on Form W-2 reflects Medicare tax withheld. Because Additional Medicare Tax is effective January 1, 2013, Forms W-2 issued in 2013 for 2012 will not reflect Additional Medicare Tax. Forms W-2 issued in 2014 for 2013, however, will reflect Additional Medicare Tax if the tax was withheld by the taxpayer's employer.*

Employer underpayments. Code Sec. 6205 provides that an employer that makes an underpayment of employment taxes (FICA, RRTA, or income tax withholding) may make interest-free payments of the tax due when certain conditions are met. Under the proposed regulations, interest-free adjustments of underpayments of Additional Medicare Tax may be made only if the error is ascertained in the same year the wages or compensation was paid unless the underpayment is attributable to an administrative error; Code Sec. 3509 worker classification; or adjustment resulting from an IRS examination (Prop. Reg. §31.6205-1(b)(4)).

Employer overpayments. Code Sec. 6413 provides that an employer that has paid more than the correct amount of employment taxes (FICA, RRTA, or income tax withholding) may make interest-free adjustments of the amount overpaid when certain conditions are met. Under the proposed regulations, interest-free adjustments of overpayments of Additional Medicare Tax may only be made if the employer ascertains the error in the year the wages or compensation was paid and repays/reimburses the employee in the amount of the overcollection before the end of the calendar year (Prop. Reg. §31.6402(a)-2(b)(3)).

Reporting by Individuals

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

Employee liability. To the extent Additional Medicare Tax is not withheld by the employer, the employee is liable for the tax. The IRS explained in the preamble

to the proposed reliance regs that it will not collect from the employer the amount of Additional Medicare Tax it failed to withhold so long as the employee pays the tax. However, the IRS cautions that the employer would be liable for penalties or additions to tax for failing to withhold (Prop. Reg. §31.3102-4(c)).

Self-Employed Individuals

The Medicare portion of self-employment tax is imposed on all earnings from self-employment. Effective for tax years beginning after December 31, 2012, the Additional Medicare Tax increases the Medicare tax on self-employment income for any tax year beginning after December 31, 2012 by an additional 0.9 percent of self-employment income in excess of certain threshold amounts.

IMPACT: *After 2012, self-employed single individuals liable for Additional Medicare Tax will pay 2.9 percent Medicare tax on the first $200,000 of self-employment income ($250,000 in the case of married couples filing a joint return and $125,000 in the case of married individuals filing separate returns) and 3.8 percent (2.9 percent + 0.9 percent) on self-employment income in excess of $200,000 ($250,000 in the case of married couples filing joint returns and $125,000 in the case of married individuals filing separate returns).*

COMMENT: *The threshold amounts for self-employment tax purposes are the same as the threshold amounts for FICA wages. These amounts are reduced, but not below zero, by the amount of FICA wages taken into account in determining Additional Medicare Tax liability.*

EXAMPLE: *David, who is married but files separately, has $150,000 in self-employment income and $200,000 in wages during 2013. Since his wages do not exceed $200.000, his employer does not withhold Additional Medicare Tax. Nevertheless, his $200.000 in wages reduces his $125,000 threshold as a married taxpayer filing separately to $0. David is liable for Additional Medicare Tax of $675 on covered wages (0.9 percent x $75,000 ($200,000 - $125,000) and $1,350 on covered self employment income (0.9 percent x $150,000 ($150,000 - $0) for a total $2,025 liability for Additional Medicare Tax in 2013 (Prop. Reg. §1.1401-1(d)(2)(ii)).*

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