Net Investment Income Tax on Individuals

Convergence 2014

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History

• The Health Care and Education Reconciliation Act of 2010
  – Added the Net Investment Income Tax (NIIT) as Section 1411 of the Internal Revenue Code
    • Effective for taxable years beginning after December 31, 2012
• On December 5, 2012, the Treasury Department and the IRS issued proposed regulations relating to the NIIT
• On November 26, 2013, the Treasury Department and the IRS issued final regulations and additional proposed regulations relating to the NIIT
  – 163 pages of preamble
  – 140 pages of regulations
Observations

• We now have three separate tax systems
  – Regular income tax
  – Alternative Minimum Tax
  – NIIT

• The NIIT borrows heavily from Section 469
  – Thus, one must understand Section 469 in order to understand the NIIT

• The NIIT rules are complex

• The preamble to the final regulations is a Rosetta Stone
  – The final regulations would be near impossible to accurately understand without the preamble
• All IRC provisions that apply for federal income tax purposes apply for NIIT purposes unless otherwise indicated
  – Income excluded for federal income tax purposes is also excluded for NIIT purposes
  – Deferral or disallowance provisions applicable for federal income tax purposes are also applicable for NIIT purposes

• The applicable threshold amount is not reduced or prorated for a taxable year of less than 12 months
  – Unless the short taxable year results from a change in accounting period
• For taxable years beginning before January 1, 2014, taxpayers may rely on either the proposed regulations or the final regulations
  – The final regulations must be applied for taxable years beginning after 12/31/13
• The tax is computed on Form 8960 – Net Investment Income Tax
  – Draft form was released on August 7, 2013
  – Draft instruction were released on January 6, 2014
Taxpayers Subject to Tax

• Only **certain** individuals, estates, and trusts are subject to the NIIT

• Corporations and partnerships are **not** subject to the NIIT
  – But partners and S corporation shareholders may be subject to tax on the partnership’s/S corporation’s NII
Application to Individuals

- The NIIT applies to an individual who is a **citizen** or **resident** of the United States.
- The NIIT does **not** apply to nonresident alien individuals.
- A **dual-status** resident alien is not subject to the NIIT for the portion of the year for which he or she is treated as a nonresident alien.
- In the case of a U.S. citizen or resident that is married to a nonresident alien individual, the spouses are treated as **married filing separately** for NIIT purposes.
  - Thus, the threshold for the U.S. citizen/resident is only $125,000.
  - The nonresident alien is not subject to the NIIT.
• Married taxpayers who file a joint federal income tax return pursuant to a Section 6013(g) or a Section 6013(h) election also may make the election for NIIT purposes
  – In which case, the married-filing-jointly threshold will apply and both spouses will be subject to the NIIT
• A bona fide resident of a U.S. territory is subject to the NIIT only if he or she is required to file a U.S. income tax return
The NIIT is equal to 3.8% of the lesser of:

- Net investment income, or
- Modified adjusted gross income in excess of:
  - $200,000 for single individuals
  - $250,000 for married couples filing a joint return
  - $125,000 for married couples filing separate returns
  - The above amounts are not indexed for inflation
• Net investment income equals
  – Gross investment income less
  – Properly allocable deductions
Gross Investment Income

1. Interest, dividends, annuities, royalties, and rents
   – Unless such income is derived in the ordinary course of a non-passive trade or business other than trading in financial instruments or commodities

2. Income from a trade or business that is a passive activity (within the meaning of Section 469)

3. Income from a trade or business of trading in financial instruments or commodities

4. Net gain from the disposition of property
   – Unless the property is used in a non-passive trade or business other than trading in financial instruments or commodities

5. Income earned on an investment of working capital
• Gross investment income does not include:
  – Wages
  – Unemployment compensation
  – Operating income from a business in which the taxpayer materially participates
    • Unless the business involves trading in financial instruments or commodities
  – Social Security benefits
• Gross investment income does **not include** (cont.):
  – Alimony
  – Tax-exempt interest
  – Gain excluded under Sections 121, 1031, etc.
  – Self-employment income
  – Distributions from qualified retirement plans and IRAs
    • Including net unrealized appreciation on employer securities
• Gross investment income does not include (cont.):
  – Interest income on loans and investments made in the ordinary course of a non-passive trade or business of lending money
  – Interest on accounts receivable arising in the ordinary course of a non-passive trade or business if credit is customarily offered to the customers of such business
• Gross investment income does **not** include (cont.):
  
  – *Income* from investments made in the ordinary course of a non-passive trade or business of furnishing *insurance* or *annuity contracts* or *reinsuring risks* underwritten by insurance companies

  – *Royalties* derived in the ordinary course of a non-passive trade or business of *licensing* intangible *property*
• Deductions attributable to rents and royalties
• Trade and business deductions attributable to
  – Passive activities
    • But only to the extent such deductions are allowed for income tax purposes
  – Trades or businesses of trading in financial instruments or commodities
    • Including, in the case of a Section 475 trader, ordinary losses in excess of ordinary gains and net capital gain
• Penalties imposed on the early withdrawal of funds from a time savings account or CD
• The NII portion of a net operating loss
• Investment interest expense
Properly Allocable Deductions (cont.)

• Investment expenses
• Foreign and state income taxes on items of GII
  – Foreign income taxes are not allowed as a deduction if a foreign tax credit is claimed
• Ordinary and necessary expenses incurred in connection with the determination, collection, or refund of any tax
  – To the extent they are allocable to GII
• Amortizable bond premium on a taxable bond
• In the case of an estate or trust, fiduciary fees and legal fees
  – To the extent they are allocable to GII
• The $3,000 net capital loss allowed under Section 1211(b)
Example

Individual A is a 40% shareholder in SCo, an S Corporation. SCo is a passive activity to A, and the only passive activity owned by A. In Year 1 SCo reported a loss of $11,000 to A which was comprised of gross operating income of $29,000 and operating deductions of $40,000. Section 469 limits A’s passive activity deductions to A’s passive activity income ($29,000). Similarly, for NIIT purposes, A’s properly allocable deductions attributable to SCo are also limited to $29,000. Thus, A’s NII from SCo is zero ($29,000 NII - $29,000 properly allocable deductions).
Properly Allocable Deductions That are Miscellaneous Itemized Deductions

- Any properly allocable deduction that is subject to
  - The 2-percent floor on miscellaneous itemized deductions, or
  - The overall limitation on itemized deductions

- Is allowed in determining NII only to the extent the item is deductible for income tax purposes after application of the limitations
  - The 2-percent floor limit is applied before the overall limitation
    » See Reg. Sec. 1.1411-4(f)(7)(iv) for an example
Items that are not properly allocable deductions:

- Moving expenses
- Expenses that are not deductible for income tax purposes
  - For example, interest and investment expenses associated with tax-exempt bonds
- Alimony
- Contributions to an IRA or qualified plan
- Standard deduction
- Personal exemption
- Charitable contributions
- Medical expenses
- Mortgage interest on a personal residence
- Real estate taxes on personal-use property
Passive Activities

- **Trades or businesses** that are passive activities to the taxpayer within the meaning of Section 469
  - Not all Section 469 passive activities involve the conduct of a Section 162 trade or business
    - For example, some rental activities may not rise to the level of a Section 162 trade or business

- Any income or gain re-characterized by Section 469 as “not from a passive activity” is similarly treated for NIIT purposes
  - And, thus, is **not** includible in NII
    - But, if the re-characterized income is further characterized as portfolio income, then such income is treated as from a passive activity for NIIT purposes
A, an unmarried individual, rents a commercial building to B for $50,000. A is not involved in the rental activity on a regular and continuous basis and, thus, A’s rental activity does not involve the conduct of a trade or business. But, under Section 469(c)(2), A’s rental activity is still a passive activity. Because the rental activity does not constitute the conduct of a trade or business, the $50,000 of rental income is not included in A’s NII as gross income from a passive activity. However, the $50,000 of rental income is nonetheless included in A’s NII as rents (because rents are included in NII unless they are derived from a non-passive trade or business).
A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours (and, as a result, X, Y, and Z are considered “significant participation activities”). A’s net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows:

- X = $600 gross - $200 deductions = $400 net
- Y = $700 gross - $1,000 deductions = ($300) net
- Z = $900 gross - $300 deductions = $600 net

$2,200 $1,500 $700
A’s passive activity gross income from significant participation passive activities exceeds A’s passive activity deductions from significant participation passive activities by $700 ($2,200 - $1,500). Thus, pursuant to Reg. Sec. 1.469-2T(f)(2), a ratable portion of A’s gross income from activities X and Z (the activities with net passive income) is treated as gross income that is not from a passive activity. Accordingly, $280 of gross income from activity X ($400 x $700/$1,000) and $420 of gross income from activity Z ($600 x $700/$1,000) is treated as gross income that is not from a passive activity.
Similarly, this same amount of income is excluded from NII. Thus, A’s NII from activities X, Y, and Z is zero, determined as follows:

- $X = \$600 - \$280 - \$200 = \$120$
- $Y = \$700 - \$0 - \$1,000 = (\$300)$
- $Z = \$900 - \$420 - \$300 = \underline{\$180}$
  \[ \underline{\$0} \]
• Any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.

• Any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.
  – As a result, such items of gross income and/or net gain will be includible in NII.
A, an unmarried individual, operates a restaurant and materially participates in the business. A owns and conducts the restaurant business through S, an S corporation wholly-owned by A. S is able to pay all of the restaurant’s current obligations with cash flow generated by the restaurant. S utilizes an interest-bearing checking account at a local bank to make daily deposits of cash receipts generated by the restaurant, and also to pay the recurring ordinary and necessary business expenses of the restaurant. The average daily balance of the checking account is approximately $2,500. In addition, S has set aside $20,000 for the potential future needs of the business in case the daily cash flow into and from the checking account becomes insufficient to pay the restaurant’s recurring business expenses. S deposits and maintains the $20,000 in an interest-bearing savings account.
Both the $2,500 average daily balance of the checking account and the $20,000 savings account balance constitute working capital. Thus, the interest generated by this working capital will not be treated as derived in the ordinary course of S’s restaurant business. Accordingly, this interest income will constitute NII.
Sale of an Interest in a Partnership or S Corporation

• Gain or loss realized upon the disposition of an interest in a partnership or S corporation that is attributable to non-passive activities is excluded from NII

• Two methods for calculating the amount of gain or loss includible in NII
  – Primary Method
  – Optional Simplified Reporting Method

• Information disclosure rules now apply for partnerships, S corporations, and transferors
A materially participating transferor must calculate the amount of gain or loss includible in NII by reference to the activity gain or loss amounts computed under Reg. Sec. 1.469-2T(e)(3)

- Thus, the amount of gain or loss includible in the transferor’s NII is the allocable share of net gains and net losses from a hypothetical sale of
  - Activities in which the transferor does not materially participate
  - Activities involving the trading of financial instruments or commodities
  - Investment assets
A owns a one-half interest in P, a calendar year partnership. In Year 1, A sells her interest for $200,000. A’s adjusted basis for the interest sold is $120,000. Thus, A recognizes $80,000 of gain from the sale for income tax purposes.

P is engaged in three trade or business activities – X, Y, and Z – none of which involve trading in financial instruments or commodities. P also owns marketable securities.
For Year 1, A materially participates in activity Z, but she does not materially participate in activities X and Y. Because P is engaged in at least one trade or business that is not passive to A, some of A’s gain on the sale of her interest in P may be excluded from NII.

The fair market value and adjusted basis of the gross assets used in P’s activities are as follows:
### Example (cont.)

<table>
<thead>
<tr>
<th>Activity</th>
<th>Adj Basis</th>
<th>FMV</th>
<th>Gain/(Loss)</th>
<th>A’s Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>X (Passive)</td>
<td>136,000</td>
<td>96,000</td>
<td>(40,000)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Y (Passive)</td>
<td>60,000</td>
<td>124,000</td>
<td>64,000</td>
<td>32,000</td>
</tr>
<tr>
<td>Z (Nonpassive)</td>
<td>40,000</td>
<td>160,000</td>
<td>120,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Securities</td>
<td>4,000</td>
<td>20,000</td>
<td>16,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
<td>400,000</td>
<td>160,000</td>
<td>80,000</td>
</tr>
</tbody>
</table>
A’s allocable share of gain from P’s passive activities and investment assets is $20,000 (($20,000) from X + $32,000 from Y + $8,000 from securities). As a result, A must include in NII $20,000 of the $80,000 gain from the sale of her interest in P.
Optional Simplified Method

• The amount of gain or loss includible in NII is determined by multiplying the transferor’s gain or loss for income tax purposes by a fraction
  – The numerator of which is the sum of the income, gain, loss, and deduction items includible in NII that are allocated to the transferor during the disposition year and the preceding two years
  – The denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the disposition year and the preceding two years
Example

A’s owns a one-half interest in P, a partnership. In Year 1, A sells the interest for $2,000,000. A’s adjusted basis for the interest sold is $1,100,000. P is engaged in two trade or business activities, X and Y (neither of which involve trading in financial instruments or commodities), and A materially participates in activity X. P also owns marketable securities. Because A materially participates in at least one of P’s activities, some of A’s $900,000 gain realized on the sale of his interest in P may be excluded from NII.

The aggregate net income from P’s activities allocable to A for the year of disposition and the two preceding tax years is as follows:
## Activity Aggregate Income/(Loss)

<table>
<thead>
<tr>
<th>Activity</th>
<th>Aggregate Income/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>X (Nonpassive)</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Y (Passive)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Securities</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1,810,000</td>
</tr>
</tbody>
</table>
The amount of NII items allocated to A during disposition year and the two preceding years is $10,000 ($10,000 loss from Y + $20,000 income from securities). Thus, the amount of A’s gain from the sale of his interest in P includible in NII is $4,972 (900,000 x (10,000/1,810,000)).
• May **only** be used if **one** of two requirements are satisfied:

1. The transferor’s NII items percentage does not exceed 5% **and** the gain recognized for income tax purposes does not exceed $5 million

2. The gain recognized for income tax purposes does not exceed $250,000
Optional Simplified Method (cont.)

• May **not** be used in any event if:
  – The transferor held the disposed interest for less than 12 months
  – Certain contributions to or distributions from the partnership or S corporation are made during the year of disposition or the two preceding years
  – The partnership or S corporation has significantly modified the composition of its assets during the year of disposition or the two preceding years
  – The S corporation converted from a C corporation during the year of disposition or the two preceding years
  – The transferor transfers only a partial interest that does not represent a proportionate share of all of the transferor’s economic rights in the partnership
A partnership or S corporation generally must tell a transferor the amount of the transferor’s allocable share of the net gain or loss from the hypothetical sale of:

- Passive activities
- Activities of trading in financial instruments or commodities
- Investment assets

However, this information must be provided only to transferors that are not eligible to use the optional simplified reporting method.
The transferor must attach to the transferor’s income tax return for the year of disposition:

- A statement that includes:
  - The transferor’s name and TIN
  - The name and TIN of the partnership or S corporation in which the interest was transferred
  - The amount of the transferor’s gain or loss on the disposition for income tax purposes
  - The amount of adjustment to gain or loss by reason of basis differences for income tax purposes and NIIT purposes
    - Which can arise if the entity owns an interest in a CFC or PFIC
  - A copy of any information provided by the partnership or S corporation relating to the transferor’s allocable share of the net gain or loss from the hypothetical sale of passive activities
• Net gain may **not** be less than zero
• But, the $3,000 capital loss allowed by Section 1211(b) is now a properly allocable deduction for NIIT purposes
  – Thus, if a taxpayer has sufficient other investment income, the $3,000 capital loss may be used to offset that other investment income
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. In addition, A receives wages of $300,000 and earns $5,000 of interest income. For income tax purposes, A may use $3,000 of net capital loss against other income and carryover the remaining $27,000 net capital loss. For NIIT purposes, A’s net gain is zero ($10,000 - $40,000, limited to zero), and A may reduce his other investment income by the $3,000 of net capital loss allowed for income tax purposes. Thus, A’s net investment income is $2,000 ($5,000 - $3,000).
• The **carry-forward** of capital losses generally may be taken into account in computing net gain for NIIT purposes
  – Even capital loss carry-forwards generated before 2013
• However, **“excluded capital losses”** may not be taken into account in determining net gain
  – Excluded capital losses
    • Capital losses attributable to the disposition of property used in a non-passive trade or business (other than a trade or business of trading in financial instruments or commodities)
    • The portion of a capital loss from the disposition of an interest in a partnership or S corporation that is excluded from NII
• An annual adjustment to capital loss carry-forwards must be made to prevent capital losses excluded from NII in the year of recognition from becoming deductible losses in future years.

• A capital loss carry-forward from the previous year is reduced for NIIT purposes by the lesser of:
  – The amount of capital loss carry-forward taken into account in the current year for income tax purposes
  – The amount of net capital loss excluded from NII in the immediately preceding year
In Year 1, A, an unmarried individual, disposes of 100 shares of publicly traded stock for a short-term capital gain of $4,000. In addition, A disposes of a partnership interest and recognizes a long-term capital loss of $19,000, all of which is excluded from NII because A materially participated in all of the partnership’s trade or business activities (and none of those activities involved trading in financial instruments or commodities).
For income tax purposes, A reports a net capital loss of $15,000, of which $3,000 is allowed as a deduction in computing Year 1 taxable income and the remaining $12,000 is carried forward into Year 2 as a long-term capital loss.

For NIIT purposes, A reports $4,000 of net gain. The $19,000 loss is excluded in computing net gain. Therefore, there are no losses in excess of gains in Year 1 for NIIT purposes.
In Year 2, A has no capital gain or loss transactions. Thus, for income tax purposes, A reports a net capital loss of $12,000, of which $3,000 is allowed as a deduction in computing Year 2 taxable income and the remaining $9,000 is carried forward to Year 3 as a long-term capital loss.

For NIIT purposes, A must reduce the $12,000 capital loss carryover from Year 1 by the lesser of (i) the capital loss carryover taken into account in Year 2 for income tax purposes ($12,000), or (ii) the amount of net capital loss excluded from NII in Year 1 ($19,000). As a result, the amount of capital loss carryover that is taken into account by A in Year 2 for NIIT purposes is $0 ($12,000 carryover - $12,000 adjustment).
In Year 3, A recognizes a $5,000 short term capital gain from the disposition of property used in a non-passive trade or business (other than a trade or business of trading in financial instruments or commodities), and a $1,000 short-term capital loss from the disposition of publicly-traded stock.

For income tax purposes, A reports a net capital loss of $5,000 ($5,000 - $1,000 – $9,000 carryover), of which $3,000 is deductible in computing Year 3 taxable income and the remaining $2,000 is carried forward to Year 4.
For NIIT purposes, the $5,000 of gain is excluded from NII. In addition, A must reduce the $9,000 capital loss carryover from Year 2 by the lesser of (i) the amount of capital loss carryover taken into account in Year 3 for income tax purposes ($9,000), or (ii) the amount of net capital loss excluded from NII in Year 2 ($12,000). Thus, the amount of capital loss carryover that is taken into account by A for NIIT purposes is $0 ($9,000 carryover amount - $9,000 adjustment). Accordingly, only the $1,000 short-term capital loss from the disposition of the publicly traded stock is taken into account in computing NII, and A is entitled to a $1,000 deduction for NIIT purposes because the $1,000 loss is less than the amount allowed for income tax purposes ($3,000).
Self-Charged Interest Income

• Self-charged interest received from a non-passive entity is excluded from NII to the extent of the taxpayer’s allocable share of the corresponding interest expense deduction
  – Without this rule, interest income would be included in NII but the corresponding interest expense would not be deductible from NII
    • But this rule does not apply to the extent the interest expense deduction is taken into account in determining the taxpayer’s self-employment income

• See Reg. Sec. 1.469-7 for the operative mechanics
A and B, two calendar year individuals, each own 50-percent of the stock of AB, an S corporation. AB operates a restaurant in which A and B materially participate. AB borrows $50,000 from A and uses the loan proceeds in the restaurant activity. AB pays $5,000 of interest to A for the taxable year. A and B each incur $2,500 of interest expense as their distributive share of AB's interest expense.
Example

AB has self-charged interest deductions for the taxable year (i.e., the deductions for interest paid to A) and A has self-charged interest income for the taxable year (i.e., the interest paid by AB). As a result, $2,500 of A’s interest income is excluded from NII.
• Self-charged rent received from a non-passive entity is **not** passive income
  – See Reg. Sec. 1.469-2(f)(6)
• Self-charged rent received from a non-passive entity is **excluded** from NII
Example

K, an individual, is a general partner in the KLM partnership. K materially participates in KLM. K generates rental income by renting property to KLM for use in its trade or business activity. Reg. Sec. 1.469-2(f)(6) re-characterizes K's rental income from KLM as non-passive (and, thus, K may not use that rental income to offset other passive losses). As a result, the rental income is excluded from NII.
• Suspended losses from **former** passive activities are taken into account in calculating NII (as properly allocable deductions)
  – But only to the extent the net income or net gain from the former passive activities is included in net investment income that year
B, and individual taxpayer, owns a 50% interest in SCorp, an S corporation engaged in the trade or business of retail clothing sales. B also owns a single family rental property (a passive activity). B currently materially participates in the retail sales activity of SCorp, but B has $10,000 of suspended losses from prior years when the retail sales activity of SCorp was a passive activity to B. Therefore, SCorp is a former passive activity.
In Year 1, B receives $205,000 of wages, $7,000 of net income from SCorp, $500 of interest income, and $1,000 of net rental income. As a result, B’s modified adjusted gross income is $205,500 ($205,000 + $7,000 + $500 + $1,000 - $8,000 (suspended PAL)).
Example (cont.)

For purposes of calculating B’s NII, the $500 of interest income and the $1,000 of net rental income are included in NII. The $7,000 of non-passive income from SCorp is excluded from NII. As a result, $7,000 of the $8,000 suspended PAL allowed for income tax purposes is not allowed for NIIT purposes. Thus, B’s NII is $500 ($500 + $1,000 - $1,000 (suspended PAL)).
• Suspended losses from a passive activity that is fully disposed of during the year are taken into account for NIIT in the same manner in which they are taken into account for income tax purposes.
  – The suspended losses are allowed in full for NIIT purposes because they related to a period of time when the activity was a passive activity and represent true economic losses.
• The NII portion of a net operating loss deduction is allowed as a properly allocable deduction in determining NII
  – The NII portion of an NOL is the “applicable portion”
• The applicable portion is equal to the lesser of:
  – The amount of NOL for the loss year if only items of gross income that are used in determining NII and only properly allocable deductions are taken into account
  – The amount of NOL for the loss year
• The NII NOL amount **deductible** in a taxable year is equal to the total NOL deduction multiplied by a fraction:
  – The numerator is the applicable portion
  – The denominator is the total NOL
In Year 1, A, an unmarried individual, has $200,000 in wages, $50,000 in gross income from a trade or business of trading in financial instruments, $10,000 of dividends, a $1,000,000 loss from his sole proprietorship (in which he materially participates), $12,000 of investment expenses, and $250,000 of trading loss deductions. As a result, for income tax purposes, A incurs a NOL of $1,000,000 ($200,000 + $50,000 + $10,000 – $1,000,000 – $10,000 [investment expenses limited to investment income] – $250,000).
The amount of the NOL for Year 1 that A would incur if only items of gross income that are used to determine NII and only properly allocable deductions are taken into account is $200,000 ($50,000 + $10,000 - $10,000 - $250,000). Thus, the applicable portion for Year 1 is $200,000 (the lesser of $1,000,000 or $200,000) and deductible portion of the Year 1 NOL for NII is 20% ($200,000 / $1,000,000).
For Year 2, A has $250,000 of wages, no gross income from the trading activity, $300,000 of income from his sole proprietorship, and $10,000 in trading loss deductions. For income tax purposes, A deducts $540,000 of the NOL carried over from Year 1 ($250,000 + $300,000 - $10,000) and carries forward a $460,000 NOL to Year 3. For NIIT purposes, the NOL deduction is $108,000 ($540,000 x .2) and the carry-forward amount is $92,000 (460,000 x .2).
Note that A’s NII NOL carry-forward is reduced by $108,000 in Year 2 even though A’s Year 2 AGI is zero and, thus, A is not subject to the NIIT in Year 2.
Planning Ideas

• Thread the needle between NIIT and self-employment tax
• Regroup passive activities
• Focus on non-recognition transactions
• Smooth income to take advantage of thresholds
• Consider making distributions of NII from trusts and estates to beneficiaries
  – But what about capital gains?
• Material participation by a limited partner
  – If a limited partner materially participates, his or her share of the partnership’s trade or business income is **not** subject to NIIT
  – A limited partner’s share of partnership income **may not** be subject to self-employment tax to the extent that such amounts are not attributable to guaranteed payments for services rendered to the partnership
   • See IRC Section 1402(a)(13)
   • But see *Renkemeyer, Campbell & Weaver LLP*
Material Participation

• General rule – a limited partner is not considered as materially participating in any activity in which he or she is a limited partner

• Three exceptions
  – The limited partner participates in the activity for more than 500 hours during the tax year
  – The limited partner materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the tax year in question
  – The activity is a personal service activity and the limited partner materially participated in the activity for any three taxable years preceding the tax year in question
• Material participation by an S corporation shareholder
  – If an S corporation shareholder materially participates, his or her share of the S corporation’s trade or business income is not subject to NIIT
  – An S corporation shareholder’s share of the S corporation’s income may not be subject to self-employment tax
    • See Rev. Rul. 59-221
  – Reasonable compensation for services rendered is required (and this amount is subject to employment taxes)
    • See Rev. Rul. 74-44
    • See Radtke, Joly, and Watson
Reasonable Compensation Considerations

- How much profit is derived from the shareholder’s personal services in relation to services of other workers and factors such as tangible capital and goodwill?
  - If other employees/shareholders/capital/goodwill are important in generating profits, a lower salary for the shareholder is justifiable
- Consider the shareholder’s education, training, and experience
- Compare the shareholder’s salary to like individuals from available salary survey data (such as industry salary surveys)
- Avoid setting an arbitrary salary level near the maximum Social Security wage base
  - This is a red flag
Regroup Passive Activities

• Reg. Sec. 1.469-4 permits taxpayers to group one or more trade or business activities or one or more rental activities into a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss.

  – Advantages and disadvantages to grouping
    • If two or more activities are grouped into one activity, the taxpayer may be more likely to meet the material participation standard.
    • But, if the grouped activity is still passive, the taxpayer will not be able to deduct suspended losses when he or she disposes of only one of the activities.

• Reg. Sec. 1.469-4(e) provides that once a taxpayer has grouped activities, he or she may not regroup those activities in subsequent years.
• Reg. Sec. 1.469-11 provides individuals, estates, and trusts a one-time opportunity to regroup their activities in the first taxable year beginning after December 31, 2012, in which:
  – The individual, estate, or trust meets the applicable income threshold
  – The individual, estate, or trust has NII

• An individual, estate, or trust may also regroup on an amended return, but only if the individual, estate, or trust was not subject to the NIIT on its original return and, because of a change to the original return, the individual, estate, or trust is now subject to the NIIT

• Partnerships and S corporations may not regroup their activities