



Net Investment Income Tax Nightmares *(NIIT is Not Just a Nit)*

Austin Tax Study Group

Headliners

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Net Investment Income Tax Nightmares

(or NIIT is Not Just a Nit)

I. Synopsis

As part of the 2010 enactment and funding of broad based healthcare reform and the expansion of healthcare coverage to more uninsured individuals, Congress enacted a “net investment income tax” at rate of 3.8% (“NIIT”). The NIIT was intended to apply to certain types of net income described as “net investment income” (“NII”), applying to that type of income and the affected taxpayers beginning on January 1, 2013¹.

The type of income targeted by the NIIT can be described as a category of income that is “unearned.” Until enactment of the NIIT, this unearned income escaped any U.S. federal taxation other than regular income tax under Chapter 1 of Title 1 of the Code², whether at ordinary or capital gain tax rates, and perhaps the alternative income tax. In particular, NII certainly previously escaped taxation under the employment tax and self-employment tax regimes commonly referred to as the “social security taxes.”³ The Employment Taxes and Self Employment Taxes have long been applied to a category of income generally thought to be of the “earned” variety. “Earned” income can be thought to include income paid to and earned by taxpayers rendering of personal services by and employee to an employer or through the carrying on of a trade or business by and individual.

As will be seen however, the universe is not so neatly divided between earned and unearned income. Indeed, certain types of income and gain, no matter how much sweat and toil goes into producing them, are included within NII and thus subjected to the NIIT. In this sense, then, it can be said that some types of “earned” income will be included in the NII. Further, there is a prejudice against certain types of income in Code §1411 such that it can almost never be possible to do enough to cause that income to be treated as anything other than NII. Rents derived from real estate may fall within this category for many taxpayers.

What is clear is that amounts that can be denoted as “mailbox money” (of the type where the recipient merely walks to his or her mailbox and retrieves same) will be subject to NII if the recipient is “rich enough” as per Congress’s measuring rod to be required to pay the NIIT.

The NIIT is not applicable to business entities that are taxable in their own right under the Subtitle A of the Code. For this purpose we mean entities that are taxable in and of themselves (associations taxable as corporations with no further election in place to be treated as a pass-through) and entities that are generally exempt from federal income taxation (exempt charitable organizations, etc.). The NIIT is instead aimed specifically at individuals, including individuals who receive “unearned” income through the use of pass-through entities (such as partnerships and electing small business, or “S,”

corporations). But the individuals subject to the NIIT are only individuals who are otherwise generally subject to U.S. taxation (citizens and resident foreign persons). So our nonresident and non-citizen friends will not find themselves subject to the NIIT, whether they derive earned or unearned income from U.S. sources, and even if that income is subjected to some income tax or withholding tax at the source.

Congress’s exclusion of the nonresident aliens may have been guided by some generous perception that nonresident aliens did not present a burden on the U.S. healthcare system, expanded or not. On the other hand Congress may have believed there were some notions of international law and protocol that they could not transgress in applying the NIIT given that it had some specific healthcare related foundation. This conclusion is strange, given the clear edict that the NIIT, when collected, cannot be transferred into healthcare related trust funds.⁴

The NIIT also applies to most domestic estates and trusts, although there are exceptions; for example where those legal constructs are more or less of the pass-through variety (that is, grantor trusts) or where the beneficiaries of them are wholly of the charitable persuasion (for example, a charitable [remainder] trust). One finds an exemption for foreign trusts here also.

It is perhaps tempting to conclude that all income earned by NIIT-targeted individuals, or NIIT-targeted estates and trusts, will be subject to either the NIIT, on the one hand, or the employment taxes, on the other. The conclusion would be wrong. In some cases, the result was intentional -- certain income thresholds must be met before the NIIT will apply to a particular taxpayer even if otherwise a NIIT-targeted taxpayer. In other cases, there are certain imperfections (long-standing imperfections) in the Code and interpreting regulations that leave neat holes (loopholes if you will) whereby certain income can pass untouched by either the employment taxes or the NIIT. There are some planning opportunities here, although they are perhaps not new – the NIIT is just a new tax that they can be used to avoid.

II. Background of Statute and Regulations

A. Legislative History and the Statute. Code §1411 was enacted as the sole new section under the brand new Chapter 2A of the Code. The statute is deceptively and perhaps elegantly brief but, in a foreshadowing (and foreboding) manner, it was awarded its very own chapter under Subchapter A of the Code (Chapter 1, deals with Income Taxes, and Chapter 2, with Tax on Self-Employment Income) . This is not an insignificant matter, as will be illustrated below in examining how the NIIT interacts and intersects with other taxes and credits made applicable under the Code. Code §1411 is reproduced as Exhibit 1.

B. Proposed Regulations. On December 5, 2012, the IRS issued a handsome and voluminous set of proposed regulations (the “NIIT Regulations.”).⁵ On official government

print in the Federal Register, the preamble (“Preamble”) and regulatory text stretch some 147 pages. In the three column style of one tax service reprint, in a smallish font, they still go for nearly 40 pages. Given the timing of their issuance, they were not the type of thing one would gladly spend some time with on New Year’s Day readying for a new year of tax-lawyering. Certain overachievers certainly did, if for no other reason than to ensure that they could claim that their clients made precise estimated tax payments for 2013 on April 15, 2014 (the NIIT is subjected to the estimated tax). The heft of the NIIT Regulations made clear that the official and brief language of Code §1411 uncorked a broad, intense, detailed, and far-reaching effort by the IRS to give life, meaning, and sense to the NIIT. If there had been any doubt, Code §1411 was finally unveiled for what it was – a very, very new and substantial tax on a new type of tax base never before taxed. The NIIT statute was the proverbial tip of a glacial iceberg.

As one reads through the NIIT Regulations it becomes clear that a proper understanding and application of the NIIT requires that that one have a deep understanding of other complex Code statutes and interpreting regulations (such as the so-called “passive loss rules” under Code §469). And if that is not enough, one has to revisit, apply and understand non-statutory, but no less complex tax notions (such as identifying when a certain activity rises to the level of a trade or business and when it does not; and also, when income and deductions are incurred in the ordinary course of that trade or business). To the extent those pre-existing tax law concepts are less than clear, then that disclarity is imported into the NIIT. In summary, the NIIT and the NIIT Regulations are not the first place a new student of tax law would want to (or even could) begin their studies.

III. Fundamentals.

A. General Determination of NIIT. From an overview perspective, calculation of NII and NIIT can more or less be broken down into the following steps:

1. Determine Affected Taxpayer Determine whether the subject taxpayer is susceptible to paying the NIIT. This includes examining whether the taxpayer is within the defined group of U.S. taxpayers subjected to the NIIT and considering the overall adjusted gross income of the taxpayer to determine if certain adjusted gross income thresholds are met. This latter calculation of adjusted gross income is made by applying certain adjustments related to foreign sourced income (which will typically not be applicable to many taxpayers as explored below).

2. Determine Gross Investment Income. Next, determine the sources of the taxpayer’s gross income that may tentatively be included in “gross investment income” (“GII”) and thus wind its way into the NII calculation and be subjected to the NIIT. This requires evaluation of the taxpayer’s gross income against the various statutory categories of GI and income not within its scope. As a starting point, GI does not include income that is not currently recognizable for general income tax purposes

(for instance, Code §1031 realized but unrecognized on like-kind exchanges; also, tax exempt interest)

With respect to gross income earned from a trade or business, one must determine whether the type of trade or business, or the taxpayer’s level of participation in that trade or business, will cause the gross income to fall into GI basket. As we will see, the notion of a “trade or business” is very important in identifying what is and is not GI. As well, whether the taxpayer carries on that trade or business through an entity of some sort is likewise important.

One more point at this juncture: GI certainly includes gains on the sale of certain assets. Whether those gains ultimately make it into the GI and NII calculations again depends on just how those assets were used or held before they were sold. As a simple example, if the assets were used in a trade or business in which the taxpayer actively participates (actively within the meaning of Code §469), then the gain is excluded from GI. As another example, since a taxpayer’s personal residence is almost never used in a trade or business (at least not wholly), then gain from the sale of that residence will be included in GI, at least to the extent of relevant exclusions.

3. Determine the “Net” in NII - Properly Allocable Deductions. Once the taxpayer’s GI is identified and calculated, then “properly allocable deductions” must be applied to and deducted against that GI to arrive at the final calculation of the taxpayer’s NII. An interesting aspect of the NIIT is that GI is first identified and calculated from all sources, and then properly allocable deductions are deducted from that gross investment income to arrive at NII. As explained later, this has some planning implications.

4. Undistributed NII – Estates and Trusts. In the case of an estate or trust subject to the NIIT (and most U.S. estates of individuals and estate planning trusts are), there is one more adjustment made to derive NII to take account the deduction for distributions made to beneficiaries. When referring to the NII of an estate or trust herein, reference is being made to the “undistributed” component of that taxpayer’s NII. This notion of undistributed net investment income is discussed further at Section _____. The “distributed” NII is of course possibly subject to NIIT in the hands of the recipient beneficiary.

5. Calculate NIIT. Finally, the NIIT is calculated on the taxpayer’s NII, but on the basis of a “lesser of” calculation to take into account certain thresholds. That is, the taxpayer is subject to the NIIT on the lesser of its NII or the excess of its adjusted gross income (with a few adjustments) over relevant thresholds. While examined in more detail later, a simple example is this: The statutory threshold for single individuals is \$200,000. If a single individual has NII of \$100,000 and modified adjusted gross income of \$250,000, then the individual will pay NIIT on \$50,000. Also as further discussed below, the threshold for estates and trusts is quite low – it is the adjusted gross income level at which the highest marginal tax rate applies to estates or trusts. But estates and trusts can effectively distribute NII to their beneficiaries causing the NIIT to fall on them, as will be discussed later.

B. Targeted Taxpayers

1. General. The NIIT does not apply to all taxpayers who might find themselves subjected to U.S. income taxation. Further, to the extent an entity or individual is exempt from U.S. income taxes, they are likewise generally exempted from the NIIT. The NIIT is a new and separate tax under the Code, with a separate tax base, and, as well, a separate targeted set of taxpayers.

2. Individuals (Direct and Pass-Through Income). The NIIT is targeted predominantly to the same taxpayers who would be subjected to the Employment Taxes were they to receive wages or earn self-employment income. Thus, to the extent individuals earn GII directly, or through Pass-Throughs, or by way of distributions from estates and trusts, they will be potentially be subjected to the NIIT.

3. Affected Trusts and Estates. As a general matter, the NIIT applies to all estates and trusts that are subject to the provisions of chapter 1, subchapter J, part I of subtitle A of the Code.⁶ This would certainly include any run-of-the mill irrevocable inter vivos or testamentary trusts and the estates of deceased individuals. Grantor trusts, however, are not subjected to the NIIT, although their owners may well be. See discussion below at III.C.1.a).

4. Electing Small Business Trusts. A special rule prevents electing small business trusts from enjoying a perceived advantage over other taxable trusts when calculating its NIIT tax base. Typically, Code §641(c)(1) provides that (A) the portion of any ESBT which consists of stock in one or more S corporations is treated as a separate trust, and (B) the amount of the tax imposed by chapter 1 on such separate trust shall be determined with certain modifications detailed in Code §641(c)(2). The NIIT Regulations preserve the chapter 1 treatment of the ESBT as two separate trusts for computational purposes but consolidates the ESBT into a single trust for determining the adjusted gross income threshold in Code §1411(a)(2)(B)(ii) such that a single adjusted gross income threshold applies.

C. Untargeted Taxpayers (Because of Who or What They Are)

1. Certain Trusts.

a) Grantor Trusts. Any trust that is treated as being owned by the grantor or another person under subpart E of subchapter J – that is a grantor trust -- is not subject to the NIIT.⁷ The person treated as owner, however, must treat all items of income and deduction earned by the trust as the owner's for Code §1411 purposes the same as for other income tax purposes. Proposed §1.1411-3(b)(5)

b) Business Trusts / State Law Trusts. The NIIT does not apply business trusts which are "eligible entities" for purposes of the entity classification rules, certain state law trusts that are subject to specific taxation regime including common trust funds taxed under Code §584 and designated settlement funds taxed under Code §468B.

c) Foreign Trusts and Estates. The IRS has at this time withheld any rules on the application of the NIIT to foreign trusts and estates, but has requested comments on how the NIIT rules might apply to such trusts and estates, including particularly to accumulation distributions from those entities to U.S. beneficiaries. Note, however, that United States beneficiaries receiving current distributions of net investment income from a foreign estate or foreign nongrantor trust will be subjected to the NIIT.

d) Tax-Exempt Trusts. Code §1411 does not apply to any trust is exempt from income tax even if the trust may be subject to tax under unrelated business taxable income. This would include the laundry list of trusts and funds created and subject to Code §§501(a), 664(c)(1), 220(e)(1), 223(e)(1), 529(a), and 530(a)). Certain of these trusts may make distributions that could be taxable to the recipient (Code §529 trust distributions not used for qualified tuition purposes), but the NIIT Regulations do not subject these to the NIIT.

e) Charitable Trusts. Code §1411(e)(2) specifically excepts from the application of the NIIT a trust which is wholly devoted to one or more of the purposes described in Code §170(c)(2)(B).

f) Charitable Remainder Trusts. The NIIT does not apply to charitable remainder trusts under Code §664, but distributions from these trusts to non-charitable beneficiaries will be subjected to distribution from them. See discussion at Section IV.C.3.

2. Nonresident Aliens. Nonresident foreign persons who are not generally subject to U.S. income taxation, are not subject to the NIIT. In the case where a U.S. taxpayer, certain modifications are made to the calculation of the couple's MAGI, GII, and NII, including a reduction of the applicable threshold for the U.S. taxpayer to that of a married person filing separately.⁸

3. Non-S Corporations. The NIIT does not apply to taxable business entities as a general matter. This would include C corporations which are corporations that cannot or have not elected to be S Corporations.

D. Gross Investment Income - Detail

1. General. The type of income subject to the NIIT is simply determined in some respects. Income that is earned from traditionally passive investment sources, such as interest, dividends, and royalties, as might be earned by the retired investor, will undoubtedly fall into the GII base and thus the NII calculation.⁹ The definition of GII, however, quickly becomes convoluted. This is at least because GII is in large part defined by reference to concepts (sometimes less than clear concepts) of a "trade or business." That is, as a general proposition, certain income may be excluded from GII if it is earned in and derived from the carrying on a trade or business. Conversely, income earned from certain trades or businesses will always be included in GII. This is either because of the nature of the

trade or business, or because the affected taxpayer does not “actively” participate in the trade or business.¹⁰ This means that the same trade or business may produce GII for one participant in that endeavor, but not another. In looking at the trade or business income that falls within GII, one begins to sense the breadth of the NIIT.

2. Ordinary Gross Investment Income - OGII – The Simple Stuff. A fundamental (and unsurprising) type of income included in NII includes gross income from interest and dividends, but NII also includes income from annuities (of the non-qualified variety – Code §72), royalties, and, last but not least, rents.¹¹ The inclusion of “rents” in this list has more than a little particular importance to those in the real estate industry. The IRS, aware of the modern financial instruments, specifically provided that amounts of income received in substitution for certain categories of income would likewise be considered OGII.¹² For purposes of this paper, “OGII” will refer to these categories of GII.

3. Excluded Income - General. Certain gross income is excluded specifically by the statute from the NIIT base. This includes the broad category of qualified retirement plan distributions from plans described in Code §§401(a), 403(a), 403(b), 408, 408A, or 457(b).¹³ Note, however, that income excluded from the NIIT base will still be included in a taxpayer’s adjusted gross income, thereby increasing the possibility of the taxpayer reaching the thresholds at which the NIIT applies. See discussion at Section III.G.1.

The statutory exemptions from NII is not all there is. Also excluded from the NIIT base are items of recognized income that are otherwise excludible under the Code, such as tax-exempt interest, unemployment compensation, and social security benefits. Code §1411 does not attempt to bring into the tax base those things that generally are excluded from gross income under the Code; the structure of the statute implies this and the NIIT Regulations leave no doubt.¹⁴

4. Excluded Income Wages and Self-Employment Earnings. Two specific categories of income that are excluded from the NIIT include income that is subject to the Employment Taxes and Self-Employment Taxes. That is, wage income and net earnings from self-employment are not subject to the NIIT.¹⁵ Specifically, wages earned by an employee are excluded from the NIIT because the employee is deemed to be engaged in a trade or business that is a Non-Passive Activity and its wages derived from that activity. Earnings from self-employment that are subject to the Self-Employment Taxes are excluded specifically by Code §1411(c)(6).

That wages and self-employment earnings are excluded from NIIT is sensible in that the NIIT was: i) borne out of the expansion of healthcare and ii) is intended to capture a large category of income that was previously not subject to the chief funding mechanism for government provided healthcare – the Medicare Tax portion of the Employment and Self-Employment Taxes. Further, there is some additional parallel between the NIIT and the Medicare Taxes. The standard Medicare Tax rate

was essentially 2.90% (1/2 paid by the employee earning wages and 1/2 by the employer in the case of an employee; all paid by the self-employed person in the case of self-employment earnings). The Healthcare Reform Act, however, also increased the Medicare Tax payable by an employee or self-employed person by 0.90% for wages or earnings in excess of effectively the same threshold amounts as applies to the NIIT. So a rate equivalent to the NIIT rate of 3.8% applies to the wages and earnings of employees and self-employed persons over certain income thresholds. The parallel is not quite complete since the base 1.45% Medicare Tax rate paid by the self-employed is deductible, while no portion of the NIIT is deductible.

5. Income from an Affected Trade or Business - BGII - General. Beyond the simple types of GII, one cannot go much further into an examination of the NIIT without understanding the heavy reliance the statute and the NIIT Regulations place on the notion of a “trade or business,” and with that, a similar reliance on the so-called “passive activity” rules found in Code §469.¹⁶ Income derived from certain trades or businesses will be included in GII, and for purposes here will be referred to as “BGII.” The NIIT Regulations are also particularly concerned with the taxation law applicable to so-called “pass-through” entities, including entities taxed as federal tax partnerships (whatever their state law form) (“Partnerships”) and electing small business corporations under Code §1362 (“S Corporations”) (“Partnerships and S Corporations will be collectively referred to as “Pass-Throughs”).

a) Passive Activity. As a guiding principle, income earned by a taxpayer from a trade or business in which the taxpayer is a passive participant will always be included in GII. Passive in this sense means that the taxpayer is a “passive” participant in the trade or business, within the meaning of Code §469, which means, further, that the taxpayer does not materially participate in the activity.¹⁷ This rule will apply whether the taxpayer carries on the trade or business as a sole proprietor or through a Pass-Through. “Passive Activity” used herein will refer to a trade or business as to which the taxpayer is not an active participant within the meaning of Code §469. The Passive Activity rules are legendary in their complexity and that complexity is imported into the NIIT. Excerpts from the administrative guidance regarding material participation are set forth in Exhibit B.

b) Non-Passive Activity. Conversely, a taxpayer who actively and “materially” participates in a trade or business will generally not have the income derived from that business included in its BGII. This is even so if the income would otherwise be OGGI if earned outside of the trade or business (for example, interest earned by a bank). But, to the contrary certain income earned on working capital within the confines of a trade or business, will be treated as OGII; this rule is to be applied similarly to the working capital rule under Code §469 regulations which convert working capital income into portfolio income, and not passive or active trade or business income. Again,

it matters not that the taxpayer carries on this trade or business directly or through a Pass-Through. In this paper “Non-Passive Activities” will refer to trades or businesses as to which the taxpayer is a material participant within the meaning of Code §469.

c) *Trader Activities - Exception to Non-Passive Activity.*¹⁸ Notwithstanding the general exclusions for Non-Passive Activities, the income from a certain type of trade or business will always be considered to be BGII, even if otherwise a Non-Passive Activity. Income earned from a trade or business of trading in financial instruments or commodities will always attract NIIT, no matter the participation level of the taxpayer. Code §1411(c)(2). The reason for this specific statutory rule comes from the passive activity regulations, particularly Treas. Regs. §1.469-1T(e)(6) which specifically characterizes trading personal property for the account of owners of interests in an entity, not a passive activity (think hedge funds). This rule allows the owners of those interest to recognize losses free of the passive activity rules. Congress, however, was concerned that gains from these activities were of the general type that should attract NIIT, hence the specific rule. These types of trades or businesses will be referred to as “Trader Activities.” The IRS refers the taxpayer and their counselors to the entire body of case law to determine what is trader, a dealer, or an investor.

d) *Excluded Income – S Corporations / Limited Partnerships.* While otherwise taxable income earned or derived through a Non-Passive Activity escapes the NIIT, it is not true to say that it must fall within the base of the Employment Taxes. Just because a particular stream of income is not subject to the Employment Taxes, does not mean that it will be subject to the NIIT.

In this regard, the Medicare Taxes, or proxies for those taxes in the way of the NIIT, do not reach every source of income. Particularly, there are certain types of income that can be said to be “earned” in every sense of the word, but that escape both the Employment Taxes and the NIIT. One example is the non-wage allocations and distributions from S Corporations to a shareholder as to which the S Corporation constitutes a Non-Passive Activity. A similar result obtains with non-guaranteed payment allocations and distributions to a limited partner of a “limited” Partnership, where that Partnership is a Non-Passive Activity with regard to that partner. Code §1401(a)(13) (In both examples, it is assumed that the activities are not Trader Activities.) Whether intentional or unintentional, these “holes” in the Employment Taxes and Self-Employment / NIIT scheme do exist, a fact recognized by IRS officials in public appearances discussing the NIIT and the NIIT Regulations. This issue is not a new one has been the subject of significant controversy, attempted regulations, but no Congressional action. That may change.

6. *Gain From Sales of Assets - AGII.* Code §1411 provides generally that net gains from the sale of assets will be including

within a taxpayer’s GII and fall within the grasp of the NIIT.¹⁹ Net gain from the sale of assets that is included in GII will be referred to herein as “AGII.” There is an exception for net gains from assets used in a certain trades or businesses. Thus, gain from the sale of an asset that is not used in a trade or business at all, will produce gain subject to NIIT. It is not surprising then, that gain from the sale of stock from which the taxpayer received dividends (and thus OGII) would be subject to NIIT. It may be surprising, however, to learn that assets that produce no income at all (not even OGII) would fall within the grasp of NIIT. Thus, even the venerable gain a taxpayer recognizes from the sale of their personal residence would be included in AGII and subject to the NIIT; the same would be true for real estate held as an investment (which, as will be discussed in more detail later, would likely include real estate held for the production of rental income in most cases).

As indicated, AGII does not include net gain derived from assets that are used in a trade or business, unless that trade or business is a Passive Activity or a Trader Activity.²⁰ There is thus an exclusion from AGII for gains derived from assets that are used in a trade or business that produces a type of income that is not subjected BGII. Gains from the sale of any other trade or business assets will produce AGII, and attract the NIIT. This notion gets quite complicated in the context of Pass-Throughs where an interest in the Pass-Through is sold as discussed in more detail in Section IV.B. This rule is taxpayer favorable, but opens the door on a whole new arena of tax complexity and compliance.

A final word at this point, it is of great significance that “net” gain is used in the statute to define the type of AGII subject to the NIIT. Simply put, “net losses” from the sale of assets do not figure into the picture in calculating AGII, GII, or NII – they are ignored in any particular tax year and cannot be used to offset any other category of GII.

7. *Unrecognized Gains.* The NIIT generally only reaches to tax items of income and gain that are recognized for general income tax purposes, but this rule is not without its exceptions. Therefore, deferred gains realized but not recognized under such tax provisions as Code §1031 will escape inclusion in AGII or GII. In some cases, in the arena of foreign cross-border sources of income, the statute and the NIIT Regulations turn otherwise excluded income into GII, and otherwise includible income into non-GII (at least on a timing basis).

E. Net Investment Income Calculation – General Deductions. Once a taxpayer’s overall GII is determined, its NII is calculated by deducting from GII the deductions that are “properly allocable” against that income to the extent they are “allowed” under subtitle A of the Code.²¹

1. *“Allowed” and “Properly Allocable” -Generally.* A determination of the deductions that can be used against GII to calculate NII requires examination of notions of both “allowed” and “properly allocable.” “Allowed” deductions is a fairly simply concept, and describes those deductions that are deductible from a taxpayer’s income after considering the

bevy of limitations and cut-backs in the Code (for example itemized deduction limitation, investment interest limitations, passive activity suspended losses, etc.). The notion of “properly allocable” found in Code §1411 is a new one but is elaborated upon and defined in the NIIT Regulations.²² In general, however, it can be thought of as those deductions incurred in the production of the various classes of GII, whether under Code §62, Code §162, Code §212, Code §167, Code §168, etc. The NIIT Regulations give considerable life to the concept. For our purposes here, deductions that are allowed in a taxable year against GII will be referred to as “Properly Allocable Deductions” and are explored below.

2. Properly Allocable Deductions – Itemized Deductions. Properly Allocable Deductions used to calculate NII include a subset of itemized deductions under Code §62 typically included within the notion of investment expenses. These include investment interest, taxes, depletion, and other deductions under Code §212 incurred for the production of income. For these purposes, the NIIT Regulations specifically include as a class of properly allowable deductions “investment expenses” as described in Code §163 dealing with limitations on investment interest.²³ Certain itemized deductions are deemed not “properly allocable” in the determination of NII, including such items as medical expenses and charitable deductions.

3. Limitations on Itemized Deductions. The Code §67 and Code §68 limitations on itemized deductions are also taken into account in determining the deductions “allowed” in determining NII. For instance, Code §67 renders certain miscellaneous itemized deductions non-deductible to the extent they do not exceed 2% of an individual’s adjusted gross income. Further, Code §68, which was revived effective for 2013, places an overall limitation on certain itemized deductions to the extent adjusted gross income thresholds are exceeded. For example, for 2013 in the case of married individuals filing joint returns, certain itemized deductions are reduced by 3% of the adjusted gross income amounts exceeding \$300,000 up to a maximum of 80% of the otherwise allowable itemized deductions. Importantly, investment interest and casualty loss deductions are excluded from both of these limitations, and certain other itemized deductions are not subject to one or the other of these limitations. For example, taxes are not included within the Code §67 limitation. The NIIT Regulations contain quite detailed calculations and examples for purposes of determining how the Code §67 and Code §68 limitations interrelate and for purposes of determining the character of the “allowable” deduction part of Properly Allocable Deductions used in determining NII.²⁴

4. Properly Allocable Deductions – Trusts and Estates. In the case of trusts and estates, there are special types of deductions considered. Properly Allocable Deductions will thus include other types of expenses typically deductible by such tax entities. These would include deductions incurred by reason of the holding of assets in the trust (for example, trustee fees). In the case of trusts and estates, however, there

is one more deduction of great importance, and that is the distributable net income deduction discussed in Section IV.C.1

5. Properly Allocable Deductions- Trade or Business Deductions. The full gamut of trade or business deductions attributable to GII, to the extent allowed for regular income tax calculation purposes, are allowed in determining NII. These deductions do not include expenses rendered in the course of serving as an employee, nor deductions used in calculating earnings from self-employment income.

6. Carryovers Generally. Deductions that otherwise properly allocable in determining NII can be carried over to subsequent taxable years if they are susceptible to the limitation and carryover provisions of the Code. For instance, As one example, investment interest expense, which may be limited in a certain taxable year under Code §163(d)(1) will be treated as paid by the taxpayer in the succeeding taxable year.²⁵ Unfortunately, excess but properly allocable deductions that exceed a taxpayer’s GII in a given year are otherwise lost unless they can be specifically carried over under a provision similar to Code §163(d)(1). Another category of losses subject to carryover are suspended losses under Code §469. These losses are specifically allowed to be used in subsequent tax years as part of Properly Allocable Deductions when they are no longer suspended due to adequate passive income to match them. The IRS has some issue with how to treat suspended losses that are released for general use upon the disposition of an entire interest in a passive activity.

7. Net Operating Losses. The NIIT Regulations specifically provide that “net operating losses” as calculated under Code §172 cannot be utilized in determining subsequent years’ properly allocable deductions. [Prop. Reg. 1.1411- (f)(1)(ii)]. The IRS has invited comments on this rules during the comment period on the NIIT Regulations. The IRS view of net operating losses is that determining the character of such losses in subsequent years for purposes of determining if they are made up of properly allocable deductions would be administratively burdensome on taxpayers. (As if the entire NIIT notion were not.)

8. Planning Aspects of Properly Allocable Deductions. Due to the fashion in which GII is determined, and then the subsequent calculation of NII, there are some noteworthy issues to consider.

The entire amount of a taxpayer’s GII is determined as a whole, before the Properly Allocable Deductions are applied to reduce GII to taxable NII. This at least means that Properly Allocable Deductions incurred in creating one bucket of GII, can potentially be used to offset another bucket of GII, to the extent there is an excess in that first bucket. Note however that net losses from the sale of assets that would otherwise be included in AGII, cannot be used to offset OGII or BGII. Conversely, however, general Properly Allocable Deductions attributable to OGII or BGII could conceptually be available to deduct against AGII.

a) Schedule K-1 Breakout. Given the manner in which GII is determined through Pass Throughs, a taxpayer will in the future likely find some additional information on their Schedule K-1 to assist them in calculating their NII. First, the Schedule K-1 would show as a line item the GII from that K-1; next the Schedule K-1 would presumably show as a line item the Properly Allocable Deductions generated at the entity level and allocated to the shareholder.

F. Undistributed Net Investment Income – Trusts and Estates. In the case of trusts and estates, determining the taxable NII requires application of one more deduction. That is, to the extent the trusts or estates NII is distributed to its beneficiaries, then the trust or estate is not taxed on that NII. From a calculation standpoint, the trust or estate is then subject to tax on only its “undistributed” net investment income. More about this calculation is discussed at Section IV.C.1.

G. Net Investment Income Tax – Calculation. The NIIT tax rate is a flat 3.8% and is applied to the NII of a taxpayer, but only to the extent that the adjusted gross income of the taxpayer exceeds certain thresholds.

1. Modified Adjusted Gross Income Threshold - Individuals. Whether the NII of a taxpayer is subjected to NIIT is limited by the extent to which the taxpayer’s “modified adjusted gross income” (“MAGI”) exceeds certain thresholds. So the NIIT applies to the lesser of the taxpayer’s NII or the excess of the taxpayer’s MAGI over the threshold amount. MAGI is calculated as the taxpayer’s adjusted gross income (as defined in Code §62 for individuals; Code §67(e) for estates and trusts). In some cases this adjusted gross income calculation is “modified” by adjustment for certain atypical types of income derived from foreign sources. In particular, investors in controlled foreign corporations and passive foreign investment companies will have certain modifications to their adjusted gross income. Further, individuals with excluded foreign earnings, will have those earnings included in their income, at least for purposes of determining whether their MAGI exceeds the relevant threshold. See discussion at Section IV.G

2. Adjusted Gross Income Threshold– Trusts and Estates. In the case of estates and trusts, the NII barometer is “adjusted gross income” under Code §67(e) after applying the adjustment for purposes of earnings from controlled foreign corporations and passive foreign investment companies. (The exclusion for foreign earnings is irrelevant to an estate or trust.). While general itemized deductions are not taken into account in calculating a trust or estates adjusted gross income, certain above the line deductions specific to trusts and estates are, as set forth in Code §67(e). The adjusted gross income of a trust or estate is further adjusted for its distributable net income deduction, which will, in turn, also reduce its NII as discussed at Section IV.C.1.

3. Thresholds.²⁶

a) Amounts

(1) Single Individuals. The MAGI threshold for a single individual is \$200,000.

(2) Married Individuals. The MAGI threshold for married individuals filing jointly is \$250,000. Should a married couple choose to file separately, the threshold is \$125,000 for each of them. This may amount to surreptitious marriage penalty.

(3) Married to Foreign Person See discussion at Section

(4) Estates / Trusts. The adjusted gross income threshold for estates and trusts is the maximum taxable income threshold at which the highest marginal income tax rate applies to the estate or trust. For 2013, the threshold for taxable estates and trusts will be \$11,950 of adjusted gross income. The compressed rates schedule applicable to estates and trusts indicates the need for planning for distributions to beneficiaries who might be under the much higher thresholds applicable to individuals.

b) Issues with Thresholds. MAGI can add up quite quickly for individuals, estates, and trusts quite quickly. For instance, adjusted gross income concepts do not include below the line deductions. Further, while there may be several categories of income not included in GII, that income will still tend to increase adjusted gross income. Planning for the timing of all sources of income, therefore, becomes of particular importance when attempting to avoid crossing the thresholds.

The threshold for individuals is not adjusted for inflation. The thresholds for estates and trust effectively are, since the tax rate tables are subject to indexing.

4. Simple Calculation of NIIT.

Using the nomenclature developed above, the NIIT calculation can be described as follows:

Calculation A: NII

Add: OGI
 BGII
 AGII (but not net loss)
 Deduct: Properly Allocable Deductions
 Deduct: Distributed NII
(for purposes of trusts and estates)
 Result: NII
(including undistributed NII for purposes of trusts and estates)

Calculation B: Threshold

Determine: MAGI
 Deduction: Relevant Threshold Amount
 Result: Maximum NII Tax Base

Calculation:

Multiply: Lesser of Result of A or B.
 Times: 3.8%
 Result NIIT

5. Characteristics of the NIIT. The NIIT, as a separate tax under the Code, has certain noteworthy characteristics in relation to its brethren.

a) Not Deductible The NIIT is not deductible. Consider this when considering that the deduction for ½ of the Medicare Taxes portion of the Self Employment Taxes is deductible.

b) Includible in Calculation Estimated Tax The NIIT is considered for purposes of calculating estimated tax payments.

c) Withholding. The NIIT is not subject to the general income tax withholding at source rules. The Preamble notes that the affected taxpayer could, however, adjust their other withholding applicable to other sources of income they may have.

d) Not Included in Regular Tax for Alternative Tax Purposes. However onerous and far-reaching the alternative minimum tax has become, the NIIT will not help matters. The NIIT is not part of the regular income tax for purposes of calculating a taxpayer's alternative minimum tax liability. The NIIT applies in addition to all other taxes under Subtitle A of the Code and the alternative minimum tax only is tested against the regular tax liability under Chapter 1 of Subtitle A.²⁷

e) Not Creditable for Foreign Tax Purposes In a conclusion that has ignited a firestorm of sorts, the IRS has said that the NIIT is not creditable against foreign taxes.

IV. Some Deeper Issues

A. "Derived From," "Ordinary Course," and "Trade or Business." As indicated elsewhere, the NIIT and the NIIT Regulations rely extensively on the notions of what is or is not a trade or business. The Non-Passive Activity exclusion of income from BGII requires that such income be derived from a trade or business in the ordinary course of that trade or business. Neither the NIIT nor the NIIT Regulations attempt to define these terms, instead directing the reader to these concepts as they have developed over time in the context of the income tax laws.²⁸ Taxpayers are thus left to that guidance, however imperfect, in determining whether activities are of such a customary, common, and ordinary character so as to constitute the ordinary course of business. Certain types of income, even if earned in the context of a trade or business, are deemed not to be derived in the ordinary course of that business for NIIT purposes. For instance, the NIIT statute provides for a working capital exception, similar to that under the Code §469 rules for passive activities. That rule converts certain interest, dividends, and similar amounts earned on working capital into portfolio income, and thus subjects such income to NIIT as OGII.²⁹

B. Sale of Pass-Through Interests. As discussed above, AGII generally includes gain from the sale of assets except to

the extent those assets are used in a Non-Passive Activity that is not a Trader Activity. The NIIT statute provides a rule to deal with this exclusion for assets used in a Pass-Through Non-Passive Activity, when an interest in that entity is sold.³⁰

1. General Rule – Asset Gain Taxable. As a general matter, gain from the sale of an interest in a Pass-Through, for example an interest in a Partnership, or the stock of an S Corporation, would be included in AGII, GII, and possibly NII. The general rule excludes from AGII only gains from the sale of assets "held" in a trade or business -- it is doubtful that a Partnership interest or S Corporation stock would qualify as such.

2. Look-Through Exception – The NIIT statute and the IRS, however, provide a taxpayer-friendly (but not accountant-friendly) set of rules to effectively "look-through" a Pass-Through to ascertain whether the gain from the sale of the Partnership or S Corporation stock should be included in AGII ("Look Through Rule").³¹ In doing so, Congress and the IRS has adopted an aggregate view of the Pass-Through entity. Essentially, the NIIT Regulations allow the taxpayer selling the Pass-Through interest to determine the taxation of the gain as if the taxpayer held the Pass-Through assets outright. The devil is very much in the details of this Look-Through Rule.

3. Application of Look-Through Rule. The NIIT Regulations devote a significant amount of text (for good reason) to setting forth how the Look Through Rule will apply. The tax practitioner familiar with the basis step-up rules applicable to Partnerships available upon certain transfers of Partnership Interests (Code §§734, 743, and 754), or required in certain circumstances (built-in loss property) will find some familiar but also unfamiliar notions here. The tax practitioner who tries to confine their practice to Pass-Throughs of the S Corporation variety will unfortunately find themselves in the midst of a lot of unfamiliar territory. The reader can refer to the NIIT Regulations for the extensive set of rules and examples, but the process in a nutshell is this:

a) Determine Whether it Matters. The general exclusion from AGII requires that the business assets being sold be held in a trade or business that is a Non-Passive Activity with regard to the taxpayer and that it is not a Trader Activity. If the Pass-Through interest being sold is in an entity as to which it is a wholly Passive Activity with regard to the taxpayer, or wholly a Trader Activity, then there is no occasion to apply the Look Through Rule. All of the net gain from sale of the entity will be AGII. On the other hand if the Pass-Through is at least partially Non-Passive Activity, then the Look Through Rule becomes relevant.

b) Calculate Gain/Loss on Sale of the Interest Itself. Assuming the Pass-Through interest is in an activity that is Non-Passive Activity, and is not a Trader Activity, then the Look-Through Rule might matter. The first calculation, then, is of the gain (or loss) recognized with regard to the sale of the Pass-Through interest. The taxpayer applies normal notions of amount realized, measured against basis,

and determines a net gain/loss amount. In the context of Partnerships, the calculation of amount realized takes into account entity level liabilities for which the selling taxpayer derived basis.

c) Calculate Gain/Loss on a Hypothetical Sale of All Assets. The fun begins once the gain on the sale of the Pass-Through interest is calculated. The next calculation requires that the taxpayer calculate a hypothetical sale of all of the assets of the Pass-Through entity for cash, on an asset-by-asset basis, and then hypothetically allocate those items of gain and loss to the taxpayer, who then nets them to determine the net adjustment described below. These allocations would be made in accord with the governing equity ownership agreement in the case of a Partnership, which may be very different from what would apply in the case of an S Corporation. In this hypothetical sale, the amount realized is deemed to be the fair market value of the assets and the basis of the assets is the basis in those assets in the hands of the entity. In the case of a Partnership, the assets' bases are adjusted for differing adjusted bases with regard to the taxpayer attributable to items such as Code §§734, 743, and 754 basis adjustments, and Code §704(c) adjustments attributable to contributed or deemed contributed property. The full plethora of adjustments that might be relevant in determining the pass-through gain from the Partnership are applied.

d) Adjust Overall Gain/Loss from Sale of the Interest. With the hypothetical asset sale gains and losses in hand, the taxpayer then adjusts their gain or loss on the sale of the Pass-Through interest as follows:

(1) Any gain on qualifying assets will reduce the overall Pass-Through interest sale gain or reduce the overall loss.

(2) Any loss on qualifying assets will increase the overall Pass-Through interest sale gain or reduce the overall loss.

The gain or loss from the sale of the Pass-Through interest that is left over after these adjustments, if any, is what winds its way into the AGII calculation for the taxpayer. Note that the Look-Through Rule is a two-way street – underlying losses in the assets of the Pass-Through, can increase the overall gain from the sale of the Pass-Through interest.

e) Other Aspects of Look-Through Rules.

(1) Installment Sale Rules. The Look-Through Rule provides rules to apply in the case of installment sales. For installment sales occurring after December 31, 2012, the adjustments are calculated in the year of the disposition and then recognized proportionally as the overall gain from the disposition is recognized. For dispositions occurring prior to January 1, 2013, the general rule is that the Look-Through Rule does not apply. The taxpayer can, however, elect to have the Look-Through Rule apply, but has to gather the

information from the year of disposition to determine the effect of the Look-Through Rule. This may be impossible in many circumstances.

(2) Distributions Creating Gain. In some circumstances, gains and losses are realized by Pass-Through taxpayers upon the receipt of distributions from the Pass-Through (for example, distribution from a Partnership to a partner in excess of basis under Coe 731). The Look-Through Rule applies in these cases also, although exactly how is uncertain. The IRS has requested further comment on how the Look-Through Rule should be applied in these circumstances.

(3) No Creation of Net Gains/Losses. The Look-Through Rule adjustments cannot be used create a net loss on a sale that otherwise resulted in a gain and vice-versa.

(4) QSST's, In the case of a QSST, the Look-Through Rule ignores the income beneficiary as an owner of the S corporation stock in determining and attributing the income tax consequences of a disposition of the stock by the QSST. Any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. The IRS has requested comments on how best to coordinate sale of S corporation stock in Treas. Regs. §1.1361-1(j)(8) and Code §1411(c)(4).

4. Problems with Look-Through Rule. As implied above, the Look-Through Rule is quite complex and byzantine in its application. The rule in effect requires every Pass-Through entity to potentially calculate something close to the calculation required under Code §754 upon every disposition of an interest by a partner or shareholder who might be subject to NIIT. Further, a Code §754 calculation may be different in many situations.

Further, a significant amount of information must pass from the Pass-Through entity to the interest-selling taxpayer with reason to make the adjustments allowed by Look-Through Rule. It is thought that a de minimis rule of some sort would be in order, and commentary from various practitioner groups will propose one of some sort. The IRS gives some hint in the NIIT Regulations that it considered same as they have requested comments on reducing the administrative burden on taxpayers created by the Look-Through Rule.

In Partnerships where no Code §754 election is in effect, and in S Corporations, there is no clear rule requiring the Pass-Through to provide the required information to the selling taxpayer so that it can apply the Look-Through Rule. The IRS has requested further comments in this regard.

C. Trust and Estate Issues

1. Undistributed Net Investment Income. In the case of an estate or trust, the NII of that entity that is subject to NIIT is the amount that is "undistributed" after considering the distributions made to beneficiaries. The notion of "undistributed net investment income" is yet another new concept under

Code §1411 - one that required the IRS come up with rules on how to calculate same which they did.³² These rules also deal with the amount of NII that is actually distributed to the beneficiaries when a distribution is made. For this purpose, the character of distributions is made by comparing the gross income from all sources with the GII of the trust prior to the distribution, under the general classification rules applicable under Code §651 and Code §661.

2. Planning Ideas – 65 Day Rule. Given the compressed rate schedules applicable to trusts, and the relatively low threshold at which the NIIT becomes applicable, the 65 day rule of Code §663(b) may become even more useful. Once a trust's tentative NIIT exposure is determined, the NIIT exposure of its beneficiaries can be compared, and perhaps distributions made prior to the end of the 65th day after the end of the relevant taxable year. Of course in some circumstances, sound estate and asset planning, including estate tax planning, concerns may trump the desire to avoid NIIT at the trust level (the trust distribution).

3. Charitable Remainder Trusts While a charitable remainder trust is not subject to the NIIT, the NIIT Regulations provide rules for annuity and unitrust distributions that will be treated as GII to non-charitable recipient beneficiaries. For these purposes, the character and distribution ordering rules under the Code §664 regulations apply to determine whether items of income allocated to annuity or unitrust payments constitute net investment income to the recipient beneficiary.³³ Thus, distributions from a charitable remainder trust to a beneficiary for a taxable year will consist of net investment income in an amount equal to the lesser of the total amount of the distributions for that year, or the current and accumulated net investment income of the charitable remainder trust. Apportionment rules apply where the trust has multiple annuity or unitrust beneficiaries. Under these rules, current and accumulated NII of the trust is deemed to be distributed before amounts that are not items of NII for purposes of section 1411. This classification of income as net investment income or non-net investment income is additional to the four tiers under section 664(b), which are still applicable. In drafting the NIIT Regulations, the IRS considered an alternative method for determining the distributed amount of NII determined on a class-by-class basis under Code §664(b) which would create a sub-class system of NII and non-NII within each class and category of the Code §664 framework. The IRS is wary whether this type of calculation would be worthwhile.

D. Tiering-Passive/Non-Passive/Trading Activities. The NIIT Regulations provide that the determination of whether an activity is a trade or business at all, or a Trading Activity, is determined at the entity level at which the activity is carried out. The layering of Pass-Throughs cannot be used to overcome the characterization of an activity as a trade or business, and whether it is a Trader Activity or not. Thus, the character of income pass-through from a lower tier Pass-Through to an upper tier Pass-Through, will maintain its character.

E. Determining Passive Activities. The notion of a whether an activity is a Passive Activity or Non-Passive Activity is determined at the taxpayer level, using all of the general passive activity rules under Code §469 and the relevant regulations. See discussion at Section III.D.5. One such subset of rules deals with the “grouping” of activities. The notion of grouping has new meaning and takes on new life under the NIIT rules.

1. Grouping. Under the passive activity rules, the notion of “grouping” of activities is a prevalent and useful feature. Grouping allows a taxpayer to mix and match different trade or business activities, where such grouping is reasonable.³⁴ Such grouping will allow the taxpayer to achieve material participation in the overall “grouped” activity where perhaps it was otherwise impossible to achieve material participation in one or more of the activities standing alone. One common planning scheme was to group activities likely to produce losses so that the taxpayer would be deemed active and thus able to recognize currently losses from that activity. Other activities likely to produce income might be left out of that grouping to intentionally fail the material participation test and thus produce passive income that could be used to offset passive losses from other sources.

2. Grouping Under the NIIT - General. With the advent of the NIIT a taxpayer's groupings may prove unwise in that income from Passive Activities is now potentially subject to the NIIT. For instance, given a choice, a taxpayer may desire for its Passive Activities to be thrown into the pot of Non-Passive Activities. Even if those Non-Passive Activities some generate income that may be subject to the Self-Employment Taxes, the result may still be better in that ½ of the Medicare Taxes are deductible, whereas none of the NIIT is.

3. Grouping Under the NIIT – Real Estate. In light of the strong propensity under the NIIT to tax real estate rents, unless derived from a Non-Passive Activity, a taxpayer may wish to rethink its grouping of real estate activities. For instance, until the NIIT came about, a real estate rental activity that was passive activity was a fairly useful passive income generator. It further did not attract Self-Employment Taxes due to a specific exclusion. Now that the NIIT will apply to rental activities that are Passive Activities, it may be wise to attempt to convert the activity into a Non-Passive Activity, through the use of the grouping rules. Under the real estate professional rules, a separate set of grouping rules applies to allow the real estate professional to group its real estate activities in order to avoid the per se passive activity categorization of rental activities.

4. Fresh Election Opportunity. Under the passive activity rules, groupings of activities, once made, were very difficult to undo. The IRS recognized in the NIIT Regulations that the groupings previously used by taxpayers may now provide unexpected results. As an act of administrative grace, the IRS in the NIIT Regulations (actually a new proposed regulation under Code §469) will allow taxpayer's to regroup their activities for the first year beginning after December 31, 2013.

5. Trusts and Estates. Determining the active or passive participation of a trust or estate under the passive loss rules has been an area fraught with uncertainty. In the past, the issue has largely been confined to determining whether the trust or estate could deduct losses from its activities. There is no general provision under applicable Code provisions providing for the distribution of losses from a trust or estate. The NIIT Regulations do not solve this problem, but only direct the taxpayer to refer to the Code §469 principles to determine when a Passive or Non-Passive Activity exists, as with individual taxpayers.³⁵ The Code §469 rules do not contain guidance with regard to when a trust or estate materially participates in activities. There is no guidance in the regulations at this time for material participation of trusts and estates. The IRS in its examination materials will generally look at the trustee's participation and, if it meets one of the relevant tests, will find material participation. Case law goes further, and will find material participation if the trustee uses agents to carry on the trade or business.³⁶ So while the uncertainty remains, if the trustee is found to materially participate in a trader or business that is not a Trader Activity, then the activity will be a Non-Passive Activity and income therefrom will not be GII.

One significant issue with trusts and estates is whether the characterization of the income at the trust level as Non-Passive Activity in this regard will carry over to the beneficiary.

F. Real Estate Issues – A Trade or Business ?

1. Rents. Rents are separately set forth as a statutory item of OGII, except to the extent derived from a Non-Passive Activity that is not a Trading Activity. Unfortunately, under the passive activity principles of Code §469, real estate rental activities are per se passive activities. Rents, it would seem, would thus always tend to be classified as a Passive Activity for purpose of the NIIT rules unless there is a way out from this per se classification.

2. Real Estate Professional. The passive activity regulations contain an escape of sorts for certain rental activities conducted by “real estate professionals.”³⁷ A taxpayer can be classified as real estate professional if they meet a special set of participation rules in the real estate business generally. If they do, then the rental income (and losses) they earn is conceptually not deemed per se to be a Passive Activity. But this is likely not enough. The question still remains whether the taxpayer materially participates in the activity and whether the activity rises to the level of a “trade or business.” The NIIT Regulations hint that it is indeed within the realm of possibility that even though a rental activity is a Non-Passive Activity under the rule mentioned, the activity still may not give rise to the level of activity sufficient to constitute a trade or business. The notion of whether rental real estate activity is a trade or business has been litigated, particularly in the realm of whether the owned property constituted a capital assets or trader or business asset (thus qualifying for more favorable loss treatment on sale); the same uncertainty as expressed in those cases persists into the NIIT regime.³⁸

G. Foreign Sourced Income. The NIIT Regulations and Code §1411 contain several rules of particular importance to those investing and working abroad. They are briefly set out there.

1. Inclusion of Foreign Earned Income. Code §911 allows for the exclusion from income for certain wage earnings of individuals earned while abroad. For purposes of the MAGI calculation, this exclusion is ignored, thus creating an increased MAGI; related reductions are likewise ignored. This rule is only applicable to taxpayers otherwise subject to the NIIT.

2. CFCs and PFICs. Under the Code certain income earned through corporate entities is deemed earned by the U.S. shareholder in the year it earned by the corporation. These rules apply generally to the so-called “controlled foreign corporations” and “passive foreign investment companies” and can be thought to generally convert these foreign entities into “pass-throughs” in a limited sense.³⁹ As a general rule under the NIIT Regulations, however, the inclusion amounts required under the CFC and PFIC rules will not be included in income in the year of inclusion under the normal CFC and PFIC rules. Instead, the amounts will be included in income (and thus adjusted gross income and perhaps GII) when actual distributions are made. These rules apply to all taxpayers otherwise subject to the NIIT. Taxpayers can make an election to reverse the operation of this rule.

Exhibit 1
Code Section 1411
Internal Revenue Code
§ 1411 Imposition of tax.

(a) In general.

Except as provided in subsection (e) —

(1) Application to individuals.

In the case of an individual, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax equal to 3.8 percent of the lesser of—

- (A) net investment income for such taxable year, or
- (B) the excess (if any) of—
 - (i) the modified adjusted gross income for such taxable year, over
 - (ii) the threshold amount.

(2) Application to estates and trusts.

In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of—

- (A) the undistributed net investment income for such taxable year, or
- (B) the excess (if any) of—
 - (i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over
 - (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

(b) Threshold amount.

For purposes of this chapter, the term “threshold amount” means—

- (1)** in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), \$250,000,
- (2)** in the case of a married taxpayer (as defined in section 7703) filing a separate return, 1/2 of the dollar amount determined under paragraph (1), and
- (3)** in any other case, \$200,000.

(c) Net investment income.

For purposes of this chapter—

(1) In general.

The term “net investment income” means the excess (if any) of—

- (A) the sum of—
 - (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),
 - (ii) other gross income derived from a trade or business described in paragraph (2), and
 - (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2), over

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

(2) Trades and businesses to which tax applies.

A trade or business is described in this paragraph if such trade or business is—

(A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or

(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

(3) Income on investment of working capital subject to tax.

A rule similar to the rule of section 469(e)(1)(B) shall apply for purposes of this subsection.

(4) Exception for certain active interests in partnerships and S corporations.

In the case of a disposition of an interest in a partnership or S corporation—

(A) gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest, and

(B) a rule similar to the rule of subparagraph (A) shall apply to a loss from such disposition.

(5) Exception for distributions from qualified plans.

The term “net investment income” shall not include any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b).

(6) Special rule.

Net investment income shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b).

(d) Modified adjusted gross income.

For purposes of this chapter, the term “modified adjusted gross income” means adjusted gross income increased by the excess of—

(1) the amount excluded from gross income under section 911(a)(1), over

(2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).

(e) Nonapplication of section.

This section shall not apply to—

(1) a nonresident alien, or

(2) a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).

Exhibit B

Federal Regulations

Reg §1.469-5T. Material participation (temporary).

(a) In general.

Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

- (1)** The individual participates in the activity for more than 500 hours during such year.
- (2)** The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
- (3)** The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
- (4)** The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
- (5)** The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
- (6)** The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
- (7)** Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) Facts and circumstances.

(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b).

* * * * *

(ii) Certain management activities. An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) Participation less than 100 hours. If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) Significant participation activity.

(1) In general. For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity—

(i) Is a trade or business activity (within the meaning of §1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) Significant participation. An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) Personal service activity. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in—

- (1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or
- (2) Any other trade or business in which capital is not a material income-producing factor.

(e) Treatment of limited partners.

(1) General rule. Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

- (i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and
- (ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) Exceptions. Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) Limited partnership interest.

(i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

(ii) Limited partner holding general partner interest. A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) Participation.

(1) [Reserved] See §1.469-5(f)(1) for rules relating to this paragraph.

(2) Exceptions.

(i) Certain work not customarily done by owners. Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if—

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) Participation as an investor.

(A) In general. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) Work done in individual's capacity as an investor. For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

- (1) Studying and reviewing financial statements or reports on operations of the activity;
- (2) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and
- (3) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) Participation of spouse. In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.

(4) Methods of proof. The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(g) Material participation of trusts and estates. [Reserved]

(h) Miscellaneous rules.

* * * * *

(i) [Reserved]

(j) Material participation for preceding taxable years. [Reserved] See §1.469-5(j) for rules relating to this paragraph.

T.D. 8175, 2/19/88, amend T.D. 8253, 5/11/89, T.D. 8417, 5/11/92 .

¹ *Health Care and Education Reconciliation Act of 2010 (Pub. L. 111-152, 124 Stat. 1029) Section 1402(a)(1), effective for taxable years beginning after December 31, 2012., adding section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code (“Healthcare Reform Act”).*

² “Code” refers to the Internal Revenue Code of 1986, as amended, Title 26, USCA (and boy has it been).

³ *Old-Age, Survivor, and Disability Insurance Tax of 6.20% applicable to both employer and employee on wages; Code §3111(a) (“OASDIT”), and the Medicare or hospital insurance tax (“Medicare Tax”) applied at a rate of 1.45% each to the employer and employee on wages, for a total tax of 15.30%. Code §3101(a) and (b)(1), referred to herein as the “Employment Taxes.” Similar OASDIT and Medicare Taxes are applied to net earnings from self-employment under Code §§1401(a) and (b)(1), referred to herein as the “Self Employment Taxes.” The OASDIT component of the Employment Taxes and Self Employment Taxes is subject to a maximum wages/earnings limitation of \$113,700 in 2013, but the Medicare Tax component applies to all wages/earnings. Further, the Healthcare Reform Act also raised the employee /self-employed share of the Medicare Tax by an additional 0.9%, thus making the total Medicare Tax rate 3.8% for certain high income taxpayers. Thus the total Self-Employment Tax or Employment Tax load for these high earners will reach 16.20% on the first \$113,700 of wage or self-employment income.*

⁴ *Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11), at 363 (“General Explanation”).*

⁵ *Federal Register, Vol. 77, No. 234, December 5, 2012.*

⁶ *Prop. Reg. 1.1411-3(a)(1)(i).*

⁷ *Code §671 through Code §679*

⁸ *Code §1411(e)(1).*

⁹ “Passively” is used here in a quite general sense and not intended to bring in notions of Code §469. That will come soon enough.

¹⁰ “Actively” as used here does implicate the passive activity rules under Code §469.

¹¹ *Prop. Regs. §1.1411-4.*

¹² *Prop. Regs. §1.1411-4(a)(1)(i).*

¹³ *Prop. Regs. §1.1411-8.*

¹⁴ *Prop. Regs. §1.1411-1.*

¹⁵ *Prop. Regs. §1.1411-9.*

¹⁶ *Code §1411(c)(1)(A), (c)(2); Prop. Regs. §1.1411-5.*

¹⁷ *Code §469(h) generally requires regular, continuous and substantial participation in the operations of the business to meet material participation standard and for losses to be fully deductible; Treas. Regs. §1.469-5T(a) further sets out the seven general administrative tests for meeting the material participation standard.*

¹⁸ *Prop. Regs. §1.1411-8; Preamble Section 6.C.*

¹⁹ *Code §; Prop. Regs. §1.1411-4(d).*

²⁰ *Code §1411(c)(1)(A)(iii)*

²¹ *Prop. Regs. §1.1411-(f).*

²² *Prop. Regs. §1.1411-4(f).*

²³ _____

²⁴ *Prop. Regs. §1.1411- 1.1411-4(g)*

²⁵ *Prop. Regs. §1.1411-4(f)(3)(a).*

²⁶ *Code §1411(b).*

²⁷ *Code §1411(a)(1), (2).*

²⁸ *Preamble, 5.A(b)(vi), 6.*

²⁹ *Code §1411(c)(3); Prop. Regs. §1.1411-6.*

³⁰ *Code §1411(c)(4); Prop. Regs. §1.1411-7*

³¹ *Code §1411(c)(4); Prop. Regs. §1.1411-7.*

³² *Prop. Regs. §1.1411-3.*

³³ *NIIT Regulations §1.1411-3(c)(2)(i)*

³⁴ *Treas. Regs. §1.469-4.*

³⁵ *See footnote 17.*

³⁶ _____

³⁷ *See Reiner v. U.S., 222 F.2d 770 (7th Cir. 1955); cf. Chicago Title & Trust Co. v. U.S., 209 F.2d 773 (7th Cir. 1954).*

³⁸ *Code §957; Code §1297.*