

Client Alert

IRS RELEASES RELIANCE REGULATIONS ON NEW 3.8 PERCENT TAX ON “NET INVESTMENT INCOME”

December 21, 2012

On November 30, 2012, the Internal Revenue Service (“IRS”) issued proposed regulations on the operation of the unearned income Medicare contribution tax which was enacted as Section 1411 of the Internal Revenue Code of 1986, as amended, as part of the Health Care and Education Reconciliation Act of 2010 (P.L. 11-152).

The proposed regulations are generally proposed to be effective for tax years beginning after calendar year 2013, and the IRS has indicated its intention to issue final regulations sometime in 2013. In the meantime, the IRS stated that taxpayers generally may rely on the proposed regulations.

BACKGROUND

Under Section 1411, beginning in 2013, any U.S. citizen or tax resident of the United States will be required to pay a 3.8% tax on the lesser of (i) the individual’s “net investment income” for the taxable year, or (ii) the excess, if any, of the individual’s “modified adjusted gross income”(“MAGI”) above a threshold amount.¹

“Net investment income” (“NII”) means (a) the sum of:

- (1) gross income from interest (not including tax exempt interest), dividends, annuities, royalties and rents, other than such income derived in the ordinary course of a trade or business that is neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities (“Category 1 NII”),

¹ The threshold amount is \$250,000 for a married taxpayer filing jointly, \$125,000 for a married taxpayer filing separately and \$200,000 for a single taxpayer. These threshold amounts are not indexed for inflation. The proposed regulations are also applicable to certain estates and trusts. Nonresident aliens are not subject to the tax on NII.

- (2) gross income (other than Category 1 NII or Category 3 NII) that is derived from a trade or business that is a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and
- (3) net gain attributable to the disposition of property,² other than property held in a trade or business that is neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities (“Category 3 NII”),

over

- (b) allowable deductions properly allocable to such gross income or gain.³

From a general planning perspective, taxpayers may want to consider this new tax in determining whether to sell appreciated investment assets before the January 1, 2013 effective date. On the other hand, holding onto depreciated investment assets until after 2012 could be beneficial because losses from sales in 2013 and beyond generally would be considered in determining “net gains” subject to this tax and therefore could shelter individuals from the higher future tax rates on gains that are treated as NII.

HIGHLIGHTS OF THE PROPOSED REGULATIONS

Income and gains earned by a partnership or S corporation. Where an individual earns an item of income or gain through ownership of an entity treated as a partnership or S corporation:

- (i) the determination of whether the item is “derived in” a trade or business is made at the entity level,
- (ii) the determination of whether a trade or business is a passive activity with respect to the individual is made at the individual level in accordance with the passive activity loss rules of Section 469, and
- (iii) the determination of whether a trade or business involves trading in financial instruments or commodities is made at the entity level.

Examples:

- For a private equity or other fund that is considered an “investor” for federal tax purposes (and is therefore treated as not engaged in a trade or business), allocations of dividend income and gain derived from investment in corporate

² Includes gain on the sale of a primary personal residence if the realized gain exceeds the amount excluded under Section 121.

³ Such deductions may in certain instances include allowable deductions carried over from a taxable year prior to the effective date of Section 1411.

portfolio companies generally would be treated by the individual partner or member of the fund as NII. Furthermore, the individual's status as an active or passive partner or member under the passive activity rules is irrelevant if the fund is treated as not engaged in a trade or business.

- NII generally would include allocations of income or gain by a hedge fund that engages in the trade or business of trading in financial instruments and/or commodities.
- NII generally would include allocations by a partnership of net income from active business operations to an individual partner that does not “materially participate” in the business.

Sale of an interest in a partnership or S corporation. In general, an interest in a partnership or S corporation is not considered property held in a trade or business for purposes of this tax. Therefore, gain or loss from the sale of a passthrough interest generally would be treated as Category 3 NII. However, under a special “look-thru” rule, such gain is limited to the amount of net gain that would be taken into account as NII if the partnership or S corporation sold all of its assets at fair market value immediately before the disposition of the interest. Accordingly, all of the gain or loss from the sale of a passthrough interest generally would be treated as NII where (i) the passthrough entity is not engaged in a trade or business, (ii) the trade or business of the passthrough entity is a passive activity with respect to the transferor of the interest, or (iii) the passthrough entity is in the business of trading in financial instruments or commodities.

Finally, please note that the proposed regulations have special rules addressing the treatment of qualified plan distributions, and income and distributions derived from investments by U.S. individuals in “controlled foreign corporations” and “passive foreign investment companies”.

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We will continue to monitor developments regarding the proposed regulations, which remain subject to change. In the meantime, if you have questions or would like to discuss these rules, please contact Isaac Grossman (igrossman@morrisoncohen.com; 212.735.8735), Michael Weinstein (mweinstein@morrisoncohen.com; 212.735.8746) or Michael Kearney (mkearney@morrisoncohen.com; 212.735.8649).

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