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3.8% Net Investment Income Tax for Real Estate Investors and Partnership Members: Maximizing Planning Opportunities

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Net Investment Income Tax for Real Estate Investors

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Overview of Structure of Net Investment Income Tax

Overview of Structure of Net Investment Income Tax

- Enacted as part of Patient Protection and Affordable Care Act in 2010
- New Internal Revenue Code §1411
- Effective 2013 tax year
- Applies to individuals, estates, and trusts

Overview of Structure of Net Investment Income Tax

- For individuals, tax is 3.8% of *lesser* of:
  - **Net investment income** for the tax year, or
  - The **excess, if any, of modified adjusted gross income** (MAGI) for the tax year **over the applicable threshold amount**.
- For estates and trusts, tax is 3.8% of the net investment income for the tax year, if and to the extent there is:
  - Undistributed net investment income, and
  - AGI exceeds the dollar amount at which highest fiduciary income tax bracket for year begins.
    - $12,300 for 2015

Overview of Structure of Net Investment Income Tax (cont.)

- **Net investment income** = Applicable investment income less allowable deductions allocable to the applicable investment income.
- Applicable investment income includes:
  - Gross income from:
    - Interest
    - Dividends
    - Annuities
    - Royalties
    - Rents

Overview of Structure of Net Investment Income Tax (cont.)

- Applicable investment income includes:
  - Trade or business gross income if passive
  - Trade or business gross income from trading in financial instruments or commodities
  - Net gain (to extent included in taxable income) attributable to disposition of property
    - Unless property is held in a trade or business to which the Net Investment Income Tax (NIIT) does not apply

Overview of Structure of Net Investment Income Tax (cont.)

- Applicable investment income includes:
  - Income NOT derived in ordinary course of a trade or business to which the NIIT does not apply
    - E.G.: Income from working capital of an active trade or business

Overview of Structure of Net Investment Income Tax (cont.)

- Applicable investment income does **not** include:
  - Income from active trade or business
    - But, see above for trade or business of trading in financial instruments or commodities
  - Wage and self-employment income
  - Income exempt from income tax
    - E.G. Tax-exempt interest income
  - Distributions from qualified retirement plans

Overview of Structure of Net Investment Income Tax (cont.)

- **Modified adjusted gross income:**
  - Adjusted gross income increased by excess of:
    - Income excluded under IRC §911(a)(1) foreign earned income exclusion, over
    - Any deductions (if taken into account in computing AGI) or exclusions with respect to the income excluded under IRC §911(a)(1) above.
- **Applicable threshold amount:**
  - $250,000 MFJ, $125,000 MFS, $200,000 HOH or single or qualifying widower

Overview of Structure of Net Investment Income Tax (cont.)

- The timing, exclusion and deferral rules for the "regular" income tax also govern net investment income.
- So, gains deferred under the installment method are also deferred for NIIT purposes.
- Other examples:
  – sale of principal residence
  – like-kind exchanges

Real Estate Professional

- **General Rule**
  - The rental income must be attributable to the taxpayer's rental real estate trade or business and
  - The trade or business must not be a passive activity under Section 469. Note that rental activities are treated as per se passive activities unless the taxpayer is a real estate professional ("REP").

- **Real Estate Professional**
  - Performs more than 750 hours of services in real property trades or businesses in which such taxpayer materially participates; and
  - More than half of the personal services performed during the taxable year must be performed in real property trades or businesses in which the taxpayer materially participates.

- **Material Participation**
  - Meets one of the 7 tests under Sec. 1.469-5T(a).
  - If a limited partner the only tests 1, 5, and 6 applies.

Real Estate Safe Harbor

- **Rental real estate safe harbor**
  - The individual participates in one or more rental real estate activities for more than 500 hours for the tax year; or
  - The individual has participated in rental real estate activities for more than 500 hours per year in any five of the last ten tax years.

- **Rental real estate activity**
  - Tangible property held in connection with the activity is used by customers or held for use by customers, and
  - The gross income attributable to the conduct of the activity during the tax year represents amounts paid or to be paid principally for the use of the tangible property.

Regrouping Activities & Self Charged Interest

- **Regrouping activities**
  - Can regroup activities for purposes of passive activity determination starting Dec. 31, 2012.
  - Pass-through entities were not extended the opportunity to regroup.
  - An individual must respect the groupings made by pass-through entities.

- **Self-charged interest**
  - The amount of self-charged interest received from a non-passive entity which shall be excluded from NII is the taxpayer's allocable share of the deductions.
  - The rule shall not apply in a situation where the interest deduction is taken into account in determining self employment income under Sec 1401(b).

Net Operating Losses

Ordinary Loss Carryover Limitations

- 2012 proposed regulations did not allow net operating losses (NOLs) to be carried over as an allocable deduction for NII purposes
  - For example, Section 475 ordinary losses in a year in excess of other ordinary income would not be carried forward to a subsequent year to offset NII because it was part of an NOL
- Final regulations now allow a taxpayer to carryover the ordinary loss portion of an NOL that is associated with NII
  - Going forward a taxpayer must calculate a percentage equal to the NOL that would have been generated using only items of NII over the total NOL and apply the percentage to the NOL amount carried forward in each year (Section 1411 NOL)
  - If the Section 1411 NOL exceeds the NII in a given year, the excess is wasted

Netting of Gains and Losses

Gain/Loss Netting

- 2012 proposed regulations included gains and losses from Category (ii) and Category (iii)
  - Category (iii) was limited to *net gain* and could not be less than zero
  - Losses from Category (iii) could not be utilized to offset income from Category (ii).

- Final regulations fix both of these issues and NII now more closely matches NII for regular tax purposes
  - All gains and losses are included in Category (iii)
  - Category (iii) is still limited to *net gain*, however the final regs provide for taxypayers to treat any excess losses allowed for regular tax purposes (e.g. $3,000 limitation) as properly allocable deductions to offset other income for NII purposes

Proposed Regulations

Proposed Regulations

- Prop Reg §1.1411-7 Exception for dispositions of certain active interests in partnerships and S corporations
- Proposed to apply to tax years beginning after December 31, 2013
  - Taxpayers may apply to tax years beginning after December 31, 2012
- Two methods: regular and simplified

Proposed Regulations (cont.)

- Applies to sale of interest in partnership or S corporation in which the taxpayer is active
- If passive, full gain from sale is includible in net investment income
- Applies to subsidiary passthrough entity as well
  - "look-through" rule: partner or shareholder are treated as owning a proportionate share of the passthrough entity as if they owned the interest directly

Proposed Regulations (cont.)

- Regular method:
  - If transferor recognized an income tax **gain** on the disposition of the interest in the passthrough entity, the amount of the net gain included in net investment income is the *lesser* of:
    - The gain recognized for income tax purposes, or
    - The share of net gain for income tax purposes from a deemed sale of the passthrough entity's § 1411 property

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Proposed Regulations (cont.)

- Regular method (cont.):
  - If transferor recognized an income tax **loss** on the disposition of the interest in the passthrough entity, the amount of the net loss included in net investment income is the *lesser* of:
    - The loss recognized for income tax purposes, or
    - The share of net loss for income tax purposes from a deemed sale of the passthrough entity's § 1411 property

Proposed Regulations (cont.)

- Regular method (cont.):
  - §1411 property means property owned or held through a passthrough entity that, if disposed of by the entity, would result in net gain or loss allocable to the transferor of a type that's includible in determining net investment income
  - If transferor isn't eligible to use simplified method, passthrough entity must provide information to enable transferor to calculate §1411 property
    - Otherwise, it's voluntary/negotiable

Proposed Regulations (cont.)

- Simplified method:
  - Use historic distributive-share amounts received by transferor from the passthrough entity to extrapolate a percentage of the assets within the partnership or S corporation that are passive with respect to the transfer
    - E.G. if historically 10% of the income reported on the Schedule K-1 has been subject to the net investment income tax, then 10% of the gain on the disposition of the transferor's interest would be included in net investment income

Proposed Regulations (cont.)

- Simplified method (cont.):
  - To use, transferor must meet
    - 5% threshold and/or
    - $250,000 gain or loss threshold
  - Transferor can not be ineligible

Proposed Regulations (cont.)

- Simplified method (cont.):
  - 5% threshold:
    - sum of transferor's allocable share during disposition year and preceding two years of separately stated items of income, gain, loss and deduction of a type taken into account in calculating net investment income is 5% or less of sum of all separately stated items of income, gain, loss, and deduction allocated to transferor in respect of the transferred interest during the disposition year and preceding two years ("§1411 holding period"); and

Proposed Regulations (cont.)

- Simplified method (cont.):
  - 5% threshold (cont.):
    - Total amount of gain or loss recognized by transferor for income tax purposes form the disposition of interests in the passthrough entity doesn't exceed $5 million
  - $250,000 gain or loss threshold
    - Gain or loss from disposition of the interest in the passthrough entity cannot exceed $250,000

Proposed Regulations (cont.)

- Simplified method (cont.):
  - Ineligible transferors:
    - Transferor has held directly the interest in the passthrough entity for less than 12 months
    - Transferor transferred §1411 property to passthrough entity, or received distribution of property (other than §1411 property) during §1411 holding period, as part of comprehensive plan

Proposed Regulations (cont.)

- Simplified method (cont.):
  - Ineligible transferors (cont.):
    - Passthrough is partnership, and transferor transfers non-proportionate share
    - Percentage of passthrough entity's gross assets that consist of §1411 property has increased or decreased by more than 25% during §1411 holding period
    - Passthrough entity was taxable as C corporation during §1411 holding period but made S election during that period
- No special rules for partial recognition, partial disposition, or distributions transactions

Proposed Regulations (cont.)

- If transfer of interest of S corporation causes S election to terminate on day of transfer, corporation continues to be treated as S for purposes of applying Prop Reg §1.1411-7
  - Unlike Reg. §1.1362-3(a) which treats as C corporation on day of transfer
- §336(e) election & 338(h)(10) election:
  - For net investment income tax purposes, treated as fully taxable asset sale

Proposed Regulations (cont.)

- Transferor must attach statement to their return:
  - Name and Taxpayer Identification Number (TIN)
  - Name and TIN of partnership or S corporation
  - Amount of transferor's gain or loss on disposition of the interest
  - Amount of any basis adjustment
  - Copy of information provided, if any, by passthrough entity with regards to transferor's share of §1411 property

Capital Loss Carryforwards
Capital Gains Tax Planning

Capital Loss Carryforwards

- Category 3 Income – Net Gains from Disposition of Property
  - Includes net gain attributable to disposition of property, except for property held in a trade or business that is a NOT passive activity or the business of trading financial instruments or commodities (Category 2 income), reduced by any allocable deductions: and also reduced, but not below zero, by losses attributable to casualty, theft, and abandonment or other worthlessness. Net gain shall also include any gain or loss attributable to the disposition of property from the investment of working capital.

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Capital Loss Carryforwards (Cont.)

- Disposition means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition [Reg. 1.411-4(d)(1)].
- Installment method – can defer gain recognition on the sale of eligible assets until the year payments are received
- Like-kind exchanges can indefinitely defer gain on eligible exchange property

Capital Loss Carryforwards (Cont.)

- The calculation of net gain shall not be less than zero. The lower of $3,000 ($1,500 married filing separate) or excess of capital losses over gains additional loss provision is allowed for the calculation of the 3.8% NIIT [Reg. 1.411-4(f)(4)].

Capital Gains Tax Planning

- Net gain shall not include gain or loss attributable to property (other than property from the investment of working capital) held in a trade or business that is not a passive activity or a business of trading financial instruments or commodities.
- Although it may be treated as a capital gain for regular income tax, a Section 1231 gain from an active trade or business will NOT be treated as Category 3 income (it is NOT NII.)

Disposition of a Partnership and S Corporation Interests

- A Section 1411 (c)(4) disposition is the disposition of a pass-through entity (partnership or S corporation) by an individual [Prop. Reg, 1.411-7(a)(3)(i)
  a. The pass-through entity is engaged in one or more Section 162 trades or businesses or owns an interest (directly or indirectly) in another pass-through entity that is engaged in one or more Section 162 trades or businesses, other than the business of trading financial instruments or commodities, and

Disposition of a Partnership and S Corporation Interests (Cont.)

b. One or more of the Section 162 trades or businesses of the pass-through entity is not a passive activity.

Note- If the transferor materially participates in one or more of the pass-through entity's Section 162 trades or businesses, then the transferor must calculate how much of the Category 1 (regular income tax) gain or loss from the disposition to include in Category 3. Where the transferor recognizes a gain from the disposition of an interest in a pass-through entity, the amount of gain included in Category 3 is

Disposition of a Partnership and S Corporation Interests (Cont.)

a. The Category 1 gain, or
b. The transferor’s allocable share of the Category 1 net gain from a deemed sale of the pass-through entity's Section 1411 property (property tat would be included in determining NII; i.e. investment assets or assets held in a passive Section 162 business) using the passive activity rules to allocate gain or loss to activities of the pass-through entity.

Planning

Planning Considerations

- Incentive Allocation vs. Incentive Fee
  - Long Term Capital Gain Amount
  - Deductibility of Fee Expense
- Timing of income recognition (i.e.: CFC and PFIC)
- Self Employment (SE) Tax Considerations
  - Form of Management Company
  - SE v. NII Differential
- State and Local Tax (SALT) considerations
  - E.g., NYC Unincorporated Business Tax (UBT)

Planning (cont.)

- Move taxable investments into tax-exempt investments
- Roth IRAs
  - Distributions from qualified retirement plans are not subject to NIIT, and distributions from Roth IRA’s are not subject to income tax
- Shift from dividend-paying stocks to growth stocks
- Donate appreciated stocks, rather than cash, to charity

Planning (cont.)

- Passive business: if level participation is close to that considered active, increase such that activity becomes active
- Distribute out net investment income from estate or trust
- Consider distributing out S corporation stock and partnership interests from estate or trust
- Use or elect out of installment method

Planning (cont.)

- Carryovers: NOLs, PALs, etc.

Thank You

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