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3.8% Net Investment Income Tax Final IRS Regs: Maximizing Planning Opportunities

Leveraging New Rules for Regrouping, Real Estate Safe Harbor,
Sale of Closely Held Business Interests and More

TUESDAY, FEBRUARY 25, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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3.8% Net Investment Income Tax Final IRS Regs: Maximizing Planning Opportunities

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Agenda

- I. Overview of NII Tax
- II. Final Regulations
 - (a) Real estate safe harbor and self-rental property
 - (b) Regrouping activities
 - (c) Self-charged interest
 - (d) Net operating losses
 - (e) Net gains from the sale of property
- III. New Proposed Regulations
 - (a) Sale of S corporation and partnership interests
 - (b) Capital loss carryforwards
- IV. Planning Strategies

Background on NII Tax

- On March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010, which created two new "Medicare" taxes, including the NII tax under section 1411
- On June 28, 2012, the Supreme Court upheld the constitutionality of the Act in *National Federation of Independent Business v. Sebelius*
- Proposed regulations issued December 5, 2012
- Final (and new proposed) regulations issued December 2, 2013.

Overview of NII Tax

- Starting in 2013, a 3.8% Medicare tax applies to net investment income if modified adjusted gross income (MAGI) is over certain thresholds
- Thresholds
 - Married filed jointly \$250,000
 - Married filed separately \$125,000
 - Single \$200,000
 - Trusts \$11,950
- Essentially a new income tax system

Overview of NII Tax (cont.)

- The new 3.8% Medicare tax applies to the lesser of (1) the taxpayer's net investment income or (2) the excess of the taxpayer's MAGI over the threshold amounts
 - In other words, only the amount over the threshold is subject to tax

NII Tax - Example

John, a single filer, has \$180,000 in salary income and \$50,000 of net investment income. John's MAGI is \$230,000, which is over the \$200,000 threshold. John will be subject to the new 3.8% Medicare tax on the lesser of John's net investment income (\$50,000) or the excess of John's MAGI over the threshold amount ($\$230,000 - \$200,000 = \$30,000$).

- Note that John is not subject to the new 0.9% "Additional Medicare Tax" because his salary income is not in excess of the \$200,000 threshold

Net Investment Income - Four Buckets

1. Gross income from interest, dividends, royalties, rents and annuities not derived in the ordinary course of an "active" participation business
2. Gross income from a "passive" business
3. Net gain from disposition of property not held in an "active " participation business
4. Gross income from a trade or business trading in financial instruments or commodities (grouped in Bucket 2 in final regulations)

Net Investment Income Excludes:

- Income derived from "active" participation business (key exception)
- Self-employment income (although self-employment tax and the "Additional Medicare Tax" applies)
- Distributions from IRA or qualified retirement plan

Properly Allocable Deductions

- NII (all buckets) is reduced by "properly allocable" deductions
- Generally includes investment interest, investment expenses (under 163(d)(4)(C)) and certain taxes (state, local and foreign)
- Deductions allowed after "pease" and 2% floor limitations
- Foreign taxes are allocable deductions only if no foreign tax credit taken
- Expanded deductions for estates and trusts (e.g., certain legal and trustee fees)

Significant Changes & Clarification from Proposed to Final Regulations

- Guidance for real estate professionals
- Regrouping rule clarification
- Net gains from sale of property cannot be below zero, but losses in excess of gains may reduce other investment income
- Certain NOLs will be allowed in part

Significant Changes & Clarification from Proposed to Final Regulations (cont.)

- Self-charged interest clarification
- Self-charged rental clarification
- Foreign tax credit cannot be used to offset net investment income tax
- Method to determine amount of deductions permitted to offset NII

New Proposed Regulations Released with Final Regulations

- Application of NII tax to the sale of an interest in an S corporation or partnership
- Use of capital loss carryforwards to offset NII

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Real Estate Professionals

- "Real estate professionals" may treat rental real estate as nonpassive
- A "real estate professional" must satisfy the following two tests:
 - > one-half services performed in real property trades or businesses
 - > 750 hours performed in real property trades or businesses

Real Estate Professional Safe Harbor

- Rental income will be deemed derived in the ordinary course of a trade or business for "real estate professionals" who satisfy either of the following tests:
 - > 500 hours
 - 5 of the last 10 years
- Failure to satisfy the safe harbor will not prevent a taxpayer from otherwise establishing rental income is not included in NII

Self-Rental Rule

- Net rental income from an "item of property" rented for use in a trade or business activity in which the taxpayer materially participates is recharacterized as nonpassive
- Net rental loss from such "item of property" remains passive

Self-Rental Rule and NII

- Self-rental income is deemed to be derived in the ordinary course of a trade or business
 - Same rule applies for rental income where the rental activity is properly grouped with a trade or business activity and the grouped activity is non-passive

Self-Rental Rule Example

- Fred owns an S corporation interest and participates more than 500 hours per year in business operations for the S corporation. The S corporation rents land used in its business that is owned by Fred through a single-member LLC. The rental income is recharacterized as non-passive per the self rental rule. Under the final regulations, the rental income would be deemed derived in the ordinary course of business for purposes of the NII tax.

Regrouping Activities

- Regrouping is permitted in the first year in which:
 - Taxpayer meets income threshold and
 - Taxpayer has NII
- Regrouping not allowed by S corporations and partnerships
- May regroup on amended return only if not subject to NII tax on original return

Grouping Elections

- Crucial for tax planning
- A taxpayer may group activities that constitute an "appropriate economic unit" into a single activity in light of all relevant facts and circumstances, which include:
 - Similarities and differences in types of business
 - Extent of common control
 - Extent of common ownership
 - Geographical location
 - Interdependencies between activities

Planning for Regrouping

- Consider planning strategies:
 - Expansive grouping to establish material participation
 - Narrow grouping to trigger losses upon disposition
 - Passive income, which was previously desired, may generate additional tax

Self-Charged Interest

- No NII on "self-charged interest." Excluded from Bucket 1.
- Applies to interest received from active trade or business activity
- Limited to the amount that flows through as a deduction to the recipient. No C corporation exception.
- Rule does not apply if corresponding deduction is taken into account in determining SE tax

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Net Operating Losses

- "Negative" NII (*i.e.*, allocable NII deductions exceed NII income) does not carry over to reduce NII in subsequent years
- Proposed regulations also prohibited NOL deductions under section 172 from reducing NII
- Final regulations permit a deduction of the "applicable portion" of an NOL for purposes of determining NII

Net Operating Losses (cont.)

- Two-step process applied separately to each NOL loss year
- First, determine "applicable portion," then determine "section 1411 NOL"
- The sum of all section 1411 NOLs from loss years is treated as "properly allocable deduction"

Net Operating Losses (cont.)

- "Applicable portion" is the lesser of
 1. The amount of the NOL for the loss year if only items of gross income and deductions used to determine NII for the year are taken into account
 2. The total NOL for the year
- Next, the amount of the total NOL carryforward is multiplied by the following fraction:

$$\frac{\text{Applicable Portion of NOL}}{\text{Total NOL for Loss Year}}$$

- Fraction is applied to NOL actually deducted in the year to determine the "section 1411 NOL"

NOL Example

- In 2013, A has: \$200,000 in wages, \$50,000 in gross income from a trading activity, \$10,000 in dividends, \$1,000,000 in loss from an active sole proprietorship, \$12,000 of non-business investment expenses, and \$250,000 in trading loss deductions
- As a result, for income tax purposes, A sustains an NOL of \$1,000,000
- Assume no carryback
- A's NII is the excess of \$60,000 (\$50,000 trading income + \$10,000 dividend income) over \$262,000 (\$250,000 trading loss deductions plus \$12,000 nonbusiness expenses)

NOL Example (cont.)

- A's 2013 "applicable portion" is \$200,000 (\$250,000 trading loss – \$50,000 trading income), which is lesser than the total NOL of \$1,000,000
- Non-business investment expenses do not create or increase the NOL
- Fraction is .2, or $\$200,000 / \$1,000,000$. Section 1411 NOL amount is \$200,000
- 20% of NOL applied to reduce income tax is deemed to reduce section 1411 NOL (whether or not it reduces NII tax)
- For example, if \$500,000 of NOL is used in 2014 and taxable income is \$0, then 50% of section 1411 NOL (or \$100,000) is also deemed used, even if taxpayer has no NII tax for the year

Net Gains from the Disposition of Property

- Bucket 3 only includes "net gain" from property dispositions (excluding active business interests)
- Proposed regulations provided that Bucket 3 may not be less than zero

Net Gains from the Disposition of Property (cont.)

- Final regulations adopt same overall approach as proposed regulations
- However, section 165 losses are allowed as "properly allocable deductions" to the extent such losses exceed gains from dealings in property and are not taken into account in computing net gain under section 1411
- In other words, 165 losses are permitted as a deduction to the extent they are taken into account in computing regular taxable income
- \$3,000 capital loss is permitted to reduce NII

New Proposed Regulations

- Sale of partnership and S corporation interests
- Capital loss carryforwards

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Sale of Partnership and S corporation Interests

- Old proposed regulations calculated NII as the gain from the disposition of entity interest reduced by the gain that would have been allocated to the transferor upon a hypothetical sale of entity's assets for fair market value
- New proposed regulations include gain in NII to the extent of a deemed sale of the entity's passive assets

Sale of Partnership and S corporation Interests (cont.)

- Primary calculation method
 - Gain is equal to the lesser of gain recognized under general income tax principles or gain on deemed sale of entity's Code section 1411 property
- Simplified method (optional)
 - Gain is determined by historic distributive share amounts received to establish percentage of assets that are passive with respect to specific taxpayer

Simplified Method

- Who qualifies?
 - Total gain recognized by taxpayer is less than \$250,000
 - Taxpayer's interest in entity is 5% or less during two years prior to disposition and gain recognized from disposition is less than \$5 million
- Who does not qualify?
 - Taxpayer held interest for less than 5 months
 - Certain contributions and distributions occurred during 2 year period
 - S corporation recently converted from C corporation
 - Taxpayer makes partial disposition
 - Entity has significantly modified composition of assets

Simplified Method Example

- Assume that 10% of the income stated on a K-1 is net investment income. A partner that qualifies is permitted to assume that 10% of gain from disposition would be net investment income.

Capital Loss Carryforwards

- Capital loss carryforwards are used to reduce net gain (Bucket 3)
- Applies to capital loss carryforwards incurred before effective date of NII tax
- Final regulations reserve a paragraph to provide special rules for capital loss carryforwards
- New proposed regulations look to fill this gap

Capital Loss Carryforwards (cont.)

Proposed Regulations:

- Exclude active trade or business capital losses from Bucket 3
- Exclude active flowthrough entity disposition capital losses from Bucket 3
- Provides tracking system for excluded capital losses
- Annual calculation, but only if embedded excluded capital losses

Planning Strategies

- Review tax distribution provisions
- Defer and spread out income
- Installment sales
- Like-kind (section 1031) exchanges
- Invest in passive loss generators
- Leveraged growth
- Developer carried interest in lieu of fees
- S corporation management company is "manager" of LLC

Planning Strategies (cont.)

- Nonqualified deferred compensation
- Tax-free mergers (section 368)
- Seller and management rollovers
- Manage gifts to younger generations to avoid high brackets, Medicare tax and "kiddie tax"
 - Kiddie tax applies to under 18, age 18 subject to limits and a student age 19-23 subject to limits
- Convert to a C corporation?
 - C corporation start-ups
- Invest in tax-exempt bonds
- Move investments from high-yielding dividend paying stocks to growth stocks

Planning Strategies (cont.)

- Capital loss harvesting
- Invest in tax-deferred annuities or insurance policies
- Maximize HSA contributions
- Section 529 accounts
- Qualified small business stock

Planning Opportunities: Consider S Corporation Election For Active Businesses

- Shareholder-employee can receive salary that is less than the corporation's income
- Distributions to "active" shareholder-employee should avoid 0.9% and 3.8% NII taxes
- Salary must be "reasonable" to avoid IRS recharacterization
- Less risk of self-employment tax than LLC taxed as a partnership
- Higher rate than C corporation on money left in the business

Planning Opportunities – Get Active

- Structuring to reduce passive income
 - Increase participation
 - Analyze corporate structure and grouping elections

Planning Strategies - Trusts

- Wait for IRS guidance?
- Distribute income
 - Incentive to distribute trust income to beneficiaries who may be in a lower tax bracket
 - But, also need to consider non-tax reasons to accumulate trust income
- Structure as a grantor trust
- For trusts holding S corporation stock, consider structuring as a QSST instead of an ESBT