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Marks Paneth Tax Alert: IRS issues final regulations on 3.8% net investment income tax and 0.9% additional Medicare tax

The IRS has issued final regulations addressing two new taxes under the Affordable Care Act that took effect Jan. 1, 2013: the 3.8% net investment income tax (NIIT, also known as the Medicare contribution tax), and the 0.9% additional Medicare tax. Although the final regulations for the additional Medicare tax largely mirror the proposed regs released in 2012, the final regulations for the NIIT include some significant changes from the proposed ones.

The NIIT in a nutshell

The NIIT applies to net investment income to the extent that a taxpayer's modified adjusted gross income (MAGI) exceeds the applicable threshold. The thresholds are $250,000 for joint filers; $125,000 for married taxpayers filing separately; and $200,000 for individuals, heads of household and other filers.

The NIIT is in addition to — and calculated separately from — the taxpayer's regular income tax liability (or, if applicable, alternative minimum tax liability). Individuals who are exempt from Medicare taxes may nonetheless be subject to the NIIT if they have net investment income and have MAGI above the applicable thresholds.

The tax also applies to estates and trusts that have undistributed net investment income and adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year. (For 2013, the threshold amount is $11,950; for 2014, it's $12,150.) Grantor trusts, exempt trusts (for example, charitable trusts) and trusts that aren't classified as trusts for tax purposes (for example, real estate investment trusts) aren't subject to the NIIT.

Investment income consists of:

- Gross income from interest, dividends, royalties, rents, and nonqualified annuities, except to the extent that such income is derived in the ordinary course of a trade or business that is not—(i) a passive activity with respect to the taxpayer, or (ii) a trader trading in financial instruments or commodities;

- Other gross income derived from a trade or business that is—(i) a passive activity with respect to the taxpayer, or (ii) a trader trading in financial instruments or commodities; and

- 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 that is not—(i) a passive activity with respect to the taxpayer, or (ii) a trader trading in financial instruments or commodities.

Common examples of investment income include gains from the sale of stocks, bonds and mutual funds; capital gain distributions from mutual funds; gains from the sale of a second home; and, to a certain extent, gains from the disposition of partnership or S corporation interests.[1]

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[1] The IRS has issued proposed regulations contemporaneously with the final regulations that address the calculation of NII with respect to dispositions of interests in partnerships or S corporations. Under the approach of these proposed regulations, gain or loss is included in NII only to the extent of the gain or loss from the deemed sale of the entity's passive assets.

Net investment income (NII) is calculated by deducting from investment income certain expenses that can be allocated to that income. If a taxpayer meets the applicable MAGI threshold and has net investment income, the NIIT equals 3.8% of the lesser of the amount by which the taxpayer's MAGI exceeds the threshold or the taxpayer's net investment income.

Significant provisions in the NIIT final regs

The final regulations generally follow the approach of the proposed regs released in December 2012, but the IRS did make modifications in some areas, such as the following:

Real estate professionals. The final regulations establish a new safe harbor from the NIIT for certain real estate professionals who derive rental income in the ordinary course of their real property trade or business.

Under the safe harbor, if a real estate professional participates in rental real estate activities for more than 500 hours per year, or has participated in rental real estate activities for more than 500 hours per year in five of the last 10 taxable years, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Therefore, the rental income will be excluded from the NIIT.

The regs also provide that the *failure* to satisfy the 500-hour test won't preclude a taxpayer from establishing that rental income and gain or loss from the disposition of real property should be excluded from the NIIT. A taxpayer may use other facts and circumstances specific to his or her situation to support an exclusion.

Regrouping of activities. Generally, once taxpayers have grouped their activities for purposes of applying the passive activity loss rules, they cannot regroup those activities in future years. The proposed regulations acknowledged that the enactment of the NIIT might prompt taxpayers to reconsider previous groupings. Therefore, they allowed regrouping during the first taxable year after 2012 in which the taxpayer meets the applicable income threshold and has net investment income.

The final regulations allow such regrouping even for an amended return — but only if the taxpayer wasn't subject to the NIIT on his or her original return and, because of a change to that return, the taxpayer has become subject to the NIIT for that year. For example, if an IRS examination of the return results in changes to MAGI or net investment income that trigger the NIIT, the taxpayer may regroup so long as the amended return year isn't closed by the statute of limitations.

Trusts and estates. The final regulations specifically exclude some additional trusts from the NIIT: cemetery trusts, Alaska Native Settlement Trusts, and foreign estates.[2] They also allow trusts and estates that *aren't* excluded from the NIIT to deduct fiduciary commissions, legal and accounting fees, and other trust and estate administration expenses to the extent that they're allocable to net investment income using "any reasonable method".

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[2] However, as explained in the Preamble to the final regulations, U.S. beneficiaries of foreign estates are not exempt from NIIT on distributions from foreign estates.

The final regulations also make some critical clarifications to the proposed regs. For example, the IRS made clear that the NIIT isn't exempt from estimated tax payments and that a taxpayer may not credit foreign income taxes against the NIIT.

The additional Medicare tax

The 0.9% additional Medicare tax applies to Federal Insurance Contributions Act (FICA) wages and self-employment income to the extent that they exceed the following threshold amounts: $250,000 for joint filers; $125,000 for married taxpayers filing separately; and $200,000 for individuals, heads of household and other filers.

Unlike regular Medicare taxes, the 0.9% Medicare tax doesn't include a corresponding employer portion. Employers are, however, obligated to withhold the additional tax to the extent that an employee's wages exceed $200,000 (regardless of filing status) in a calendar year.

The final regulations on the tax provide guidance on how to withhold the tax from certain wages and compensation, the reporting requirement and the employer process for adjusting under- and overpayments of the additional Medicare tax. They also explain how to file a claim for a refund of an overpayment.

What now?

The changes and clarifications to the NIIT and the additional Medicare tax could significantly affect your tax planning and payroll procedures. We can help you determine how the taxes affect your particular situation and how best to proceed to minimize your potential liability.

FOR MORE INFORMATION

If you have questions about anything you read in this alert or in our tax guide, please contact a Marks Paneth tax advisor or Robert J. Hughes, Tax Principal, by phone at 212.503.8942 or by email at rhughes@markspaneth.com.

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