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Tax Law Alert - Treasury Department And IRS Propose Rules On New Net Investment Income Tax

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Beginning in 2013, there is a new 3.8 percent tax on the investment income of individuals, estates, and trusts (the Net Investment Income Tax or "NIIT"). The Treasury Department and the IRS issued proposed regulations to implement the NIIT on Dec. 5, 2012.

For individuals, the tax is 3.8 percent of the lesser of: (1) the individual's **Net Investment Income**; or (2) the excess of the individual's **Modified Adjusted Gross Income** over a specified **Threshold Amount**. The Threshold Amount is based on your filing status:

Married filing jointly: $250,000
Qualifying widow(er) with dependent child: $250,000
Single: $200,000
Head of Household (with qualifying person): $200,000
Married filing separately: $125,000

For estates and trusts, the tax is 3.8 percent of the lesser of: (1) the estate's or trust's **Undistributed Net Investment Income**; or (2) for 2013, the excess of the estate's or trust's adjusted gross income over $11,950.

Certain individuals, estates, and trusts are excluded from the NIIT. First, the NIIT does not apply to nonresident aliens. Second, the NIIT does not apply to trusts all of the unexpired interests in which are devoted to charitable purposes.

Net Investment Income is defined as the sum of three categories of gross income and net gain less **Properly Allocable Deductions**. The three categories include:

- Gross income from interest, dividends, annuities, royalties, and rents, except if such income is derived in the ordinary course of trade or business that is neither a passive activity with respect to the individual, estate, or trust, nor a trade or business of trading in financial instruments or commodities ("**NIIT Trades or Businesses**");
- Other gross income from NIIT Trades or Businesses; and
- Net gain from the disposition of property, except property held in trades or businesses that are not NIIT Trades or Businesses.

Net Investment Income also includes income and gain on the investment of working capital. Net Investment Income does not include distributions from qualified retirement plans or amounts subject to self-employment tax.

There is also a special rule for dispositions of interests in partnerships and S corporations ("**Special Passthrough Disposition Rule**"). The Special Passthrough Disposition Rule may adjust the amount of gain or loss that is considered Net Investment Income. The proposed regulations require you to submit information to the IRS substantiating the adjustment calculated under the Special Passthrough Disposition Rule.

For individuals, estates, and trusts with income that exceeds the applicable Threshold Amount and that have Net Investment Income, certain immediate actions may be necessary.

- The NIIT is subject to the estimated tax provisions, which means that 2013 quarterly estimated tax payments should take into account the additional tax liability.
- If you receive salary and wages, you may want to increase your income tax withholding by filing a new Form W-4 to take into account the additional tax liability.

The proposed regulations provide for several elections that, depending on your circumstances, may be advantageous.

- The proposed regulations offer a one-time "regrouping" of activities for purposes of determining whether your activities are passive.
- Individuals, estates, and trusts that entered into installment sale agreements prior to 2013 may elect to apply the Special Passthrough Disposition Rule to installment payments.
- For a nonresident alien married to a U.S. citizen or resident, you may make a one-time election to be treated as a resident of the U.S. for purposes of the NIIT.
- For individuals, estates, and trusts that own interests in certain foreign corporations, you may make a one-time election to align the NIIT rules with the regular tax rules.

The deadline for submitting public comments on the proposed regulations is March 5, 2013. The Treasury Department intends to finalize the regulations by the end of 2013. However, the proposed regulations provide that taxpayers may rely on the proposed regulations until the effective date of the final regulations. Due to the complexity of the proposed regulations, individuals, estates, and trusts that are or may be subject to the NIIT should consult with counsel before making quarterly estimated tax payments, adjusting their withholding, or making any elections available under the proposed regulations.

are urged to consult your own lawyer on any specific legal questions you may have concerning your situation.