

Net Investment Income Surtax - One Year Later (Where do we go from here?)

Presented To:
EPC of Berks County
September 18, 2014

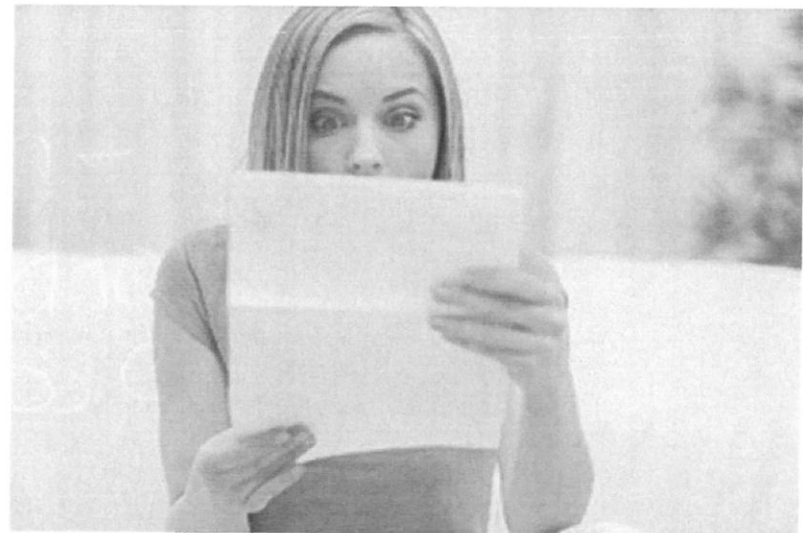
Presented by
Jordon N. Rosen, CPA, AEP®
Director, Estate & Trust Services
Belfint, Lyons & Shuman CPAs
Wilmington, DE / West Chester, PA
www.belfint.com
302.573.3911/jrosen@belfint.com



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Shock and Awe!

- The 3.8% tax on Net Investment Income (NII) left many taxpayers with sticker shock!



**Net Investment Income Tax—
Individuals, Estates, and Trusts**

Department of the Treasury
Internal Revenue Service (99)

▶ Information about Form 8960 and its separate instructions is at www.irs.gov/form8960.

Attachment
Sequence No. **72**

Name(s) shown on Form 1040 or Form 1041

Your social security number or EIN

Part I Investment Income		<input type="checkbox"/> Section 6013(g) election (see instructions)		<input type="checkbox"/> Regulations section 1.1411-10(g) election (see instructions)	
1	Taxable interest (Form 1040, line 8a; or Form 1041, line 1)		1		
2	Ordinary dividends (Form 1040, line 9a; or Form 1041, line 2a)		2		
3	Annuities from nonqualified plans (see instructions)		3		
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (Form 1040, line 17; or Form 1041, line 5)				
4b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)				
4c	Combine lines 4a and 4b		4c		
5a	Net gain or loss from disposition of property from Form 1040, combine lines 13 and 14; or from Form 1041, combine lines 4 and 7				
5b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)				
5c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)				
5d	Combine lines 5a through 5c		5d		
6	Changes to investment income for certain CFCs and PFICs (see instructions)		6		
7	Other modifications to investment income (see instructions)		7		
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7		8		
Part II Investment Expenses Allocable to Investment Income and Modifications					
9a	Investment interest expenses (see instructions)	9a			
9b	State income tax (see instructions)	9b			
9c	Miscellaneous investment expenses (see instructions)	9c			
9d	Add lines 9a, 9b, and 9c		9d		
10	Additional modifications (see instructions)		10		
11	Total deductions and modifications. Add lines 9d and 10		11		
Part III Tax Computation					
12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-		12		
Individuals:					
13	Modified adjusted gross income (see instructions)	13			
14	Threshold based on filing status (see instructions)	14			
15	Subtract line 14 from line 13. If zero or less, enter -0-	15			
16	Enter the smaller of line 12 or line 15		16		
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). Enter here and on Form 1040, line 60		17		
Estates and Trusts:					
18a	Net investment income (line 12 above)	18a			
18b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
18c	Undistributed net investment income. Subtract line 18b from 18a (see instructions)	18c			
19a	Adjusted gross income (see instructions)	19a			
19b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
19c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c		20		
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (.038). Enter here and on Form 1041, Schedule G, line 4		21		

A Quick Recap

- 3.8% tax on the lesser of –
 - Net investment income, or
 - MAGI over threshold
 - \$200,000 Single or HOH
 - \$250,000 Married
- Thresholds are not adjusted for inflation!

NII Includes

- Interest
- Dividends
- Annuities
- Royalties
- Rents (some exceptions)
- Income from passive trade/business activities flowing from S Corps and Partnerships

NII Includes – Continued

- Net gain from sale of assets
 - Stocks, bonds, real estate, etc.
 - From sale of interest in passive activities (S Corps and Partnerships)
- Earnings on working capital investment
- Taxable portion of gain from sale of residence
- Distributions from estates and trusts that pass out NII items listed above
- Trading in financial instruments and commodities

Example

John is single with MAGI of \$350,000, which includes \$10,000 interest, \$15,000 dividends, and \$75,000 capital gains.

<u>\$ 100,000</u>	NII
\$ 350,000	MAGI
- <u>200,000</u>	Threshold
<u>\$ 150,000</u>	Excess Over Threshold
\$ 100,000	Lesser of Amounts
<u>3.80%</u>	Rate
<u>\$ 3,800</u>	NII Tax

Items Not Included in NII

- Wages and self-employment income
- Tax-exempt income
- Active trade/business income
- Sale of assets in active trade/business
- Retirement plan/IRA distributions
- Excluded gain from sale of residence
- Like-kind exchanges/involuntary conversions
- Life insurance
- SSA benefits



Planning Techniques to Reduce NII Tax

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Keep NII Below the Threshold

Objective: Keep MAGI below \$200,000/\$250,000

- Use of installment sale to spread NII over several years
- Use of like-kind exchange
- Tax-exempt income
- Growth vs. income-producing investments
- ROTH distributions vs. taxable distributions
- ROTH conversion
- Income deferral (i.e., bonuses, SSA starting date, or first RMD)
- Sell high-basis assets to minimize gain

Gifts and Use of FLPs

- Transfers income off of high-income returns
- Kids get their own \$200,000 threshold
- Kiddie tax may still apply

Use of Losses and Deductions

- Investment interest expense
- Suspended passive losses reduce NII when passive activity is sold
- Net operating loss can be allocated
- Investment expenses reduce NII subject to phase-out limitations
- Rent/royalty expenses
- Early withdrawal penalty
- Harvest capital losses

Use of Losses and Deductions – Continued

- Allocable state/local taxes on NII (but must be reduced by the prior year refunds if benefit received in prior year by the deduction)
- Portion of tax return preparation fees and tax advice
- No carryover of unused portion unless otherwise used as carryover to determine taxable income in a future year (i.e., investment interest)

Investments in S Corporations/ Partnerships

- Material participation in a trade/business avoids the NII tax

Self-Rentals are NOT NII

- Owner must materially participate in trade/business, or
- Rental activity is grouped with operating trade/business

Self-Charged Interest is NOT NII

Convert Rental Real Estate to Trade/Business

- R.E. professional exception – 50%/750-hours test
- Safe-harbor material participation test
- Converts activity to trade/business income (including gain from sale)
- Regrouping allowed in first year that NII is applicable to taxpayer

3.8% NII Tax Applies to Estates and Trusts

On Lesser of

- Undistributed net investment income, or
- MAGI in excess of threshold for highest bracket (\$12,150 in 2014)

CERTAIN TRUSTS ARE EXEMPT FROM NII

1. Trusts exempt under Section 501.
2. Where all of the unexpired interest is devoted to charity under Section 170(c)(2)(B)).
3. Charitable remainder trust (although distributions to beneficiaries is NII) subject to "worse-in-first-out distribution rules.
4. Any other trust or fund that is statutorily exempt from tax.
5. Grantor trust (although items of income are NII to grantor).
6. Foreign trusts and estates (although distributions to U.S. beneficiaries are can be NII).

ELECTING SMALL BUSINESS TRUSTS

1. S-Corp and non S-corp items of NII are separately computed
2. Then aggregated for purposes of determining if amounts exceed thresholds

EXAMPLE OF ALLOCATION OF NII FOR TRUSTS AND ESTATES

Assume trust has \$15,000 dividend income, \$10,000 interest income, \$5,000 capital gain and \$75,000 distributed from an IRA. Trust distributes \$10,000 in 2013.

Total income: \$105,000
DNI: \$100,000 (does not include \$5,000 capital gain)

10% of the \$10,000 distribution is allocated to each item of DNI, thus the beneficiary reports the following income on their 1040:

Dividend income \$1,500
Interest income \$1,000
IRA distribution \$7,500

But only the dividend & interest income constitute NII for Form 8960 purposes (\$2,500) for the beneficiary.

The trust has \$27,500 of NII (\$15K + \$10K + \$5K - \$2,500).

DISTRIBUTIONS FROM A CHARITABLE REMAINDER TRUST

1. Distribution based on a “worse-in-first-out” basis, based on category of income and how it would be taxed to the beneficiary. Thus,
 - (a) ordinary income - interest, rents, royalties, non-qualified dividends, then
 - (b) capital gains - short term capital gains, un-recaptured Section 1250 gains and long term capital gains, then
 - (c) other income
2. “Excluded income” - NII tax does not apply to those amounts retained in the trust as of December 31, 2012, regardless of when they are subsequently distributed.
3. “Accumulated NII” refers to net investment income received by the CRT after 2012, less the total amount of NII distributed for all prior taxable years after 2012.
4. Beginning in 2013 – distributions first come from current and accumulated NII and then from excluded amounts (not subject tot NII tax). Will need to keep 2 sets of books to track “income” and “NII” for K-1 purposes.

EXAMPLE

Assume as of 12/31/12:

Interest	\$5000
Qualified Div	\$4000
STCG	\$4000
LTCG	\$6000

Income for 2013:

Interest	\$1000*
Qualified Div	\$1000*
LTCG	\$2000

2013 Distribution of \$10,000 – would be allocated as follows:

Interest NII	\$1,000*
Interest EXCL	\$5,000
Qualified Div NII	\$1,000*
Qualified Div EXCL	\$3,000

*THUS, TOTAL NII INCLUDED IN INCOME DISTRIBUTION FOR 2013 IS ONLY \$2,000

What's a Trustee to Do?

- Make discretionary distributions to beneficiaries if they will not be subject to 3.8% NII tax
- Use of 65-day rule
- Investment strategies to reduce NII
- Material participation in trade/business of estate/trust by fiduciary

Final Regulations Issued on Deductible Expenses for Estates and Trusts (T.D. 9664)

- Regarding expenses subject to 2% of AGI floor
- Effective for tax years beginning on or after January 1, 2015
- Closely follow the proposed regulations issued in September 2011

Noteworthy

“Commonly” or “customarily” incurred - looks at whether a hypothetical individual owning the same property would commonly or customarily incur the same expense

- Ownership Costs - Charged by virtue of being the property owner, such as condo fees, insurance, and maintenance, are subject to 2% floor. Real estate taxes are ordinary and necessary trade/business expenses and not subject to 2% floor.
- Tax Return Preparation Fees - Only those related to GST, estate, or decedent's final 1040 avoid the 2% floor.

Noteworthy – Continued

- Investment Advisory Fees - Generally subject to 2% floor, other than incremental fees charged for unusual investment advice or determining distributions/rebalancing among various beneficiaries
- Appraisal Fees - Generally fully deductible if related to estate administration except for appraisals for insurance purposes
- Fiduciary Expenses - Those not customarily incurred by individuals are fully deductible (i.e., bond fees, court costs, probate fees) as long as they relate to the estate administration and not to the ongoing trust administration

Bundling Fees

- Bundling fees which consist of both 2% floor and those not subject to the 2% floor must be allocated based on any reasonable method.
- If bundled fee is not computed on an hourly basis, the entire amount, except the investment advisory fee portion, is fully deductible.
- Out-of-pocket expenses are treated separately.
- IRS may issue safe-harbor guidance in this area.



Questions?

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