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Investment Management Tax Alerts

Treasury issues final and newly proposed regulations covering the net investment income tax

Background

Enacted in 2010 to pay, in part, for healthcare reform, the net investment income (NII) tax is imposed on "unearned income" beginning January 1, 2013. **Internal Revenue Code section 1411** imposes a 3.8 percent tax on the lower of an individual's NII or "modified adjusted gross income" above a threshold, which is $250,000 for married filing jointly taxpayers, or $200,000 for a single taxpayer.

NII essentially taxes three classes of income (after taking into account properly allocable deductions): (a) gross income from interests, dividends, rents, and royalties (portfolio bucket), (b) gross income from trading and passive activities (trading/passive bucket) and (c) net gains from dispositions from all assets other than active trades or businesses (net gain bucket).

On November 26, 2013, the Treasury released final and newly proposed regulations (the **final regulations** and the **2013 proposed regulations**), which supersede the proposed regulations released in November, 2012 (the 2012 proposed regulations) [see below for effective dates]. While we are still assessing the broader implications of the new rules, we'd like to highlight a few key items impacting the alternative investment industry.

Definition of income included in NII clarified

Trading losses

There was significant concern that gross losses from trading activities would not fully offset gross gains from trading activities. The final regulations address this concern by providing that (a) trading gains and losses should be reported in the net gain bucket as opposed to the gross gains from trading activity bucket, and (b) any excess losses will be treated as properly allocable deductions available to offset income in the other two buckets.

The effect of the excess losses being treated as allocable deductions is dependent on whether or not the client has made a mark to market election under section 475. The preamble makes it clear that a net mark to market loss may be used to offset other investment income, such as interest and dividends, in determining NII. For an investor or a trader that has not elected to mark to market, a net capital loss can be used to offset capital gains from other sources and then up to $3,000 of remaining net capital loss may be used to offset other types of investment income, with the balance carried forward to future years.

For example, assume you are a trader with gross gains of $50,000, gross losses of $70,000 and portfolio income of $20,000. Your NII is computed as follows. Your net trading income is ($20,000). The net gain bucket cannot go below zero but the ($20,000) excess is a properly allocable deduction. For regular tax, $3,000 of the capital loss is deductible and thus the $3,000 is allowed to reduce the portfolio income of $20,000. Your total NII is thus $17,000. If you elected under section 475 to mark to market, then the excess loss of $20,000 is ordinary and available to offset NII from portfolio activity. Your total NII in this case would be $0.

Notional principal contracts

The 2013 proposed regulations clarify that payments made pursuant to a notional principal contract (NPC) are taxable or deductible in computing NII to an investor. These regulations, however, provide that this rule only applies to periodic payments made under an NPC that is referenced to property (including an index) that produces (or would produce) interest, dividends, royalties, or rents if the property were held directly by the taxpayer. This leaves open the question as to whether NII includes periodic payments that are referenced to commodities or foreign exchange.

Guaranteed payment for use of capital
The 2013 proposed regulations provide that a guaranteed payment for the use of capital is NII, because it is akin to interest income.

Passive losses – regrouping

For individuals, trusts, and estates, the final regulations retain the one-time passive activity regrouping opportunity first introduced in the 2012 proposed regulations. The final regulations provide that taxpayers may regroup their activities for purposes of applying the passive activity loss rules in the first taxable year beginning after December 31, 2013 in which the taxpayer meets the applicable income threshold and has NII. A taxpayer may choose to rely on the final regulations and regroup its activities in 2013. The final regulations, however, did not extend the regrouping election to passthrough entities. Therefore, the groupings of passthrough entities that had been made in the past remain effective.

Properly allocable deductions

A taxpayer may reduce its investment income by properly allocable deductions. The final regulations make clear that amortization of bond premium is properly allocable, as are non-creditable foreign taxes and certain net operating losses.

For fund managers, the preamble to the final regulations clarifies that the manager of a trader fund may treat expenses that were not used to reduce net earnings from self-employment as properly allocable deductions. The guidance does not extend to managers of investor funds or private equity funds.

Effective dates

The NII tax is imposed on NII earned starting on January 1, 2013. The guidance makes it clear that NII should be considered quarterly when making estimated tax payments for any year in which the law is effective.

The final regulations are effective for taxable years beginning after December 31, 2013 (with one minor exception relating to charitable trusts). The 2013 proposed regulations are proposed to have the same effective date as the final regulations; however, certain provisions would apply prospectively only. Both the final and 2013 proposed regulations may be relied upon for taxable years beginning before January 1, 2014. Any elections made under the 2013 proposed regulations will take effect and remain in effect for all subsequent taxable years.

The 2012 proposed regulations may be relied on for tax years beginning before January 1, 2014. To the extent a taxpayer takes a position on a return in a taxable year beginning before January 1, 2014, that is inconsistent with the final regulations, and such position affects the treatment of items in a taxable year beginning after December 31, 2013, the taxpayer must make reasonable adjustments to retain the integrity of the taxpayer's NII tax liability in tax years beginning after December 31, 2013.

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