WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: The New Playing Field – A Review of the Net Investment Income Tax and Final Regulations.

MARKET TREND: Legacy management now includes higher income tax brackets and the imposition of new taxes encouraging a shift towards income tax planning arrangements and investments.

SYNOPSIS: The new net investment income tax ("NIIT") imposes an additional 3.8% tax on passive income received by individuals, trusts and estates. The combined impact of the NIIT and higher income tax brackets result in federal tax rates up to 43.4% on certain passive investment income. Wealth management for clients now requires long term deferred income tax planning, using annuities and life insurance, including private placement products, deferred compensation plans, charitable planning, and regrouping of business activities.

TAKE AWAYS: When the game changes, opportunities arise. NIIT and higher income tax rates create new opportunities for advisors to assist individuals and trustees with investments, compensation, and tax deferral arrangements. Planning to reduce taxes will require regular financial reviews, particularly for clients near the triggering income thresholds, and will consider the following options.

- With higher income taxes and the NIIT, life insurance products—which are taxed appropriately, generally without imposition of tax on unrealized gains on inside buildup and policy death benefits—will become more attractive.

- Higher taxes also will likely also increase interest in deferred compensation planning for key executives and higher wage earners, with corresponding opportunities for life insurance funding.

- The "fresh start" election available to clients under the final Treasury Regulations provides clients with a one-time opportunity to regroup their business activities to meet material participation requirements, thereby potentially reducing NIIT and other taxes.

- Charitable remainder trusts may be a viable option for charitably inclined clients with highly appreciated assets to sell. These trusts are excluded from NIIT, allowing deferral of both capital gains tax and NIIT on gain from the sale, as well as tax-deferred growth on the proceeds, until distributed to the beneficiary as part of an annuity or unitrust payment.

- Private placement annuities and life insurance may particularly appeal to higher earners and trustees who invest in hedge funds, commodity funds, or high-yield taxable bonds. These clients may see returns from such investments consistently taxed at the highest income tax rates but not receive offsetting distributions. Holding these type of investments through the investment account of a properly structured private placement product can defer the gain recognition and NIIT and also avoid the potential for phantom income.

PRIOR REPORTS: 12-3.1

MAJOR REFERENCES: *Internal Revenue Code § 1411; Treas. Regs. § 1.1411*.

As we approach the first tax filing deadline since the implementation of the NIIT,[1] individuals are feeling the true impact of the tax. The combined effect of higher income tax rates plus the NIIT has raised federal tax exposure on certain passive investment income to as much as 43.4% (and, when coupled with state income taxes, potentially above 50%). Although the NIIT likely has the greatest impact on high net worth clients and trusts, individuals in lower tax brackets also may feel the bite when large assets are sold. Thus, wealth preservation and legacy management now require long-term income tax planning in addition to estate and gift tax planning.

Internal Revenue Code ("**Code**") § 1411 and the corresponding final Treasury Regulations issued at the end of 2013 provide rules and guidance on how the NIIT is determined. Persons advising clients on investments and compensation arrangements, such as annuities, life insurance, and qualified and non-qualified plans, must be familiar with the NIIT rules and the planning opportunities for reducing the NIIT's impact.

DETERMINING NIIT

Individuals

The NIIT is a new, additional tax on certain items of passive income received by individuals, estates and trusts. For an individual, the tax is 3.8% of the lesser of the individual's (i) net investment income or (ii) modified adjusted gross income ("**MAGI**")[2] that exceeds the following specified threshold amounts:

Filing Status	Threshold Amount
Married Filing Jointly	$250,000
Married Filing Separately	$125,000
Single	$200,000
Head of Household	$200,000
Qualifying Widow/Widower with Dependent Child	$250,000

Example 1: T, a single taxpayer, has taxable income of $150,000 from wages and net investment income of $100,000 from a passive business interest. T's MAGI is $250,000 ($150,000 + $100,000). T's MAGI exceeds the applicable $200,000 threshold by $50,000 ($250,000-$200,000). The NIIT applies to the

lesser of $50,000 (the excess of T's MAGI over the threshold) or $100,000 (T's net investment income). Thus, T owes **<u>$1,900</u>** of NIIT ($50,000 x 3.8%).

> ***Example 2***: A and B, married, joint filers, have taxable income from wages and bonuses of $1,000,000 and net investment income of $500,000 from passive business interests. A and B's MAGI is $1,500,000 ($1,000,000 + $500,000). Their MAGI exceeds the applicable threshold by $1,250,000 ($1,500,000-$250,000). The NIIT applies to the lesser of $1,250,000 (the excess of A and B's MAGI over the threshold) or $500,000 (A and B's net investment income). Accordingly, A and B owe **<u>$19,000</u>** of NIIT ($500,000 x 3.8%).

The thresholds applicable to individuals are <u>not indexed for inflation</u>. Thus, the pool of individual taxpayers subject to the NIIT will grow over time as income levels rise.[3]

<u>Estates and Trusts – Application Threshold of Just $12,150</u>

For estates and trusts, the NIIT is 3.8% of the lesser of (i) the estate's or trust's ***undistributed*** net investment income, or (ii) the excess of the estate's or trust's MAGI over the threshold for application of the highest income tax bracket to estates and trusts ***($12,150 for 2014)***.

> ***Example 3***: Trust T, an irrevocable non-grantor trust, has undistributed net investment income of $200,000 and MAGI of $200,000. The NIIT applies to the lesser of $200,000 (Trust T's undistributed net investment income) or $187,850 (the excess of Trust T's MAGI over the applicable threshold ($200,000-$12,150)). Accordingly, Trust T owes $7,138.30 of NIIT ($187,850 x 3.8%).

The NIIT does not apply to all estates and trusts. Grantor trusts are <u>excluded</u> – instead the trust's grantor for federal income tax purposes reports the investment income on his or her personal income tax returns.[4] Other trusts that <u>are excluded</u> from NIIT include charitable trusts, qualified retirement plan trusts and charitable remainder trusts (although, as discussed below, annuity or unitrust distributions to an individual beneficiary that include investment income will be subject to NIIT in the hands of the beneficiary).[5]

WHAT IS NET INVESTMENT INCOME?

<u>Includible Investment Income</u>

The NIIT is imposed on passive investment income. Investment income for purposes of the tax generally means interest, dividends, royalties, rents, non-qualified annuities, gross income from a trade or business involving passive activities, income from a business involved in trading of financial instruments or commodities, and net capital gain from the disposition of property (other than property held in a trade or business).[6] Note however, that investment income is reduced by deductions properly allocable to such income, such as investment interest expenses, investment advisory and brokerage fees, expenses related to royalty and rental income, fiduciary expenses (with respect to estates and trusts), tax preparation fees, and state and local income taxes allocable to investment income.[7]

<u>Excludible Investment Income</u>

Net investment income ***does not include*** wages, bonuses, Social Security benefits, IRA and qualified retirement plan distributions, alimony, unemployment compensation, tax-exempt interest (such as interest from tax exempt bonds), excluded gain from the sale of a principal residence, operating income from a nonpassive business, and self-employment income.[8]

The Treasury Regulations allow rental income (generally treated as passive investment income) from a *self-rented property* (for example, where the taxpayer's active trade or business leases property from the taxpayer) to be excluded as net investment income. In addition, if the taxpayer has elected to group the passive rental activity with an active trade or business for income tax purposes, such rents also are excluded as net investment income and not subject to the NIIT.[9]

In addition, the Treasury Regulations specifically provide that *self-charged interest* received from a nonpassive activity (*i.e.*, where a taxpayer, who is not engaged in the trade or business of lending, makes a loan to a pass through entity in which the taxpayer materially participates), is excluded from net investment income.[10]

<u>Gain from Sale of a Personal Residence</u>

One source of investment income that will apply to a broad spectrum of taxpayers is capital gain on the sale of real property. Gain realized on the sale of real property is generally investment income for NIIT purposes. However, ***the NIIT does not apply to gain from the sale of a personal residence that is excluded from gross income for regular income tax purposes*** (*i.e.*, the first $250,000 of gain ($500,000 for married couples), the "**residence gain exclusion**"***)***.[11]

> ***Example 4***: A and B, married, joint filers, have wages of $500,000. They sell their personal residence, in which they have a basis of $500,000, for $3,000,000. Their taxable capital gain from the sale is $2,000,000 ($3,000,000 - $500,000 (basis) - $500,000 (residence gain exclusion)). A and B have other investment income of $200,000, resulting in total net investment income of $2,200,000. A and B's MAGI is $2,700,000 ($500,000 of wages + $2,000,000 of capital gain + $200,000 of other investment income). The NIIT applies to the lesser of $2,450,000 (the excess of A and B's MAGI over the $250,000 threshold) or $2,200,000 (A and B's net investment income). Accordingly, A and B owe $83,600 of NIIT ($2,200,000 x 3.8%).

PLANNING OPPORTUNITIES TO REDUCE NIIT

Clients who face NIIT on their 2013 net investment income are looking for ways to reduce their future NIIT exposure, which will require managing both MAGI and investment income.

<u>Life Insurance</u>. The appropriate tax treatment of life insurance products—typically without the imposition of tax on unrealized growth within the policy or on policy death benefits— make life insurance attractive to clients with NIIT exposure. Properly structured private placement products can defer gain recognition on tax-inefficient investments (such as hedge funds, commodity funds, or high-yield taxable bonds) and also avoid the potential for phantom income. Further, as long as the policy is not considered a modified endowment contract, clients can generally access values up to their basis without imposition of income tax.

<u>Deferred Annuities</u>. Deferred annuities are also taxed appropriately, without imposition of tax on internal growth, Once annuity payments begin, the accumulated gains are spread out, reducing the bite of income tax and NIIT on the distributions, particularly if the taxpayer is in a lower income tax bracket when distributions begin (like at retirement).

Harvesting Capital Gains and Losses. The Treasury Regulations clarify the ability to use capital losses to offset capital gain for NIIT purposes. Accordingly, during any year the taxpayer has high capital gains, the taxpayer can take the opportunity to divest himself of those assets that are selling at a loss, thereby reducing net investment income. Similarly, during any year the taxpayer has large losses, consideration should be given to selling assets that have large built-in gains in order to take advantage of the losses.[12]

Installment Sales. Another approach available to reduce NIIT is the use of an installment sale for the disposition of a highly appreciated asset. Installment sales spread the capital gains over a number of years, reducing the immediate imposition of NIIT, and possibly reducing NIIT depending upon the client's other net investment income, MAGI and applicable NIIT thresholds. Installment sales are sometimes possible when selling a closely held business or real estate.

Maximized Contributions to IRAs and Other Retirement Plans. Clients can reduce their MAGI by maximizing annual contributions to IRAs, 401ks and other retirement plans. In addition to reducing MAGI for the current tax year, contributions grow tax-free within the retirement plan, and distributions generally are not included as investment income for NIIT purposes.[13] It may pay to revisit certain forms of deferred benefit plans and make nondeductible contributions to an IRA.

Activity Regrouping.[14] As discussed above, income from passive activities (activities in which the taxpayer does not materially participate) is net investment income subject to the NIIT. Generally the passive activity grouping rules prevented taxpayers from "regrouping" in subsequent tax years to group passive and nonpassive activities (businesses in which the taxpayer materially participates). The Treasury Regulations, however, provide taxpayers with a one-time "fresh start" election, allowing clients to regroup certain multiple business activities to meet material participation requirements and remove such income from the NIIT net. For example, if a taxpayer has passive rental income, he may be able to regroup the rental activity with a non-passive business. The "fresh start" regrouping election is not available for partnerships or S corporations. If the election is available to the client, the election must be made for the first tax year the client is subject to the NIIT.

Material Participation in the Business. Another way a taxpayer can reduce NIIT is to increase his material participation in the business, thereby converting income from a passive activity into income from a nonpassive activity and removing the income from NIIT exposure.

Managing Income Distributions from Estates and Trusts. Estates and trusts are exposed to NIIT at much lower thresholds than individual taxpayers. As discussed above, estates and trusts are subject to NIIT on the lesser of the ***undistributed*** net investment income for the tax year, or the excess, if any, of MAGI over the threshold for application of the highest tax bracket to estate and trusts (***$12,150 for 2014***). Estates and trusts ***reach the highest federal income tax bracket of 39.6% very quickly, resulting in a combined federal income tax and NIIT exposure of 43.4% on most of its undistributed investment income (exclusive of any state and local income tax impact)***. Beneficiaries, on the other hand, may be in lower income tax brackets and have higher NIIT thresholds. Going forward, fiduciaries should analyze the impact of both regular income tax and the NIIT on the estate or trust as well as on the beneficiaries and consider making distributions of net income to beneficiaries by December 31st (or within 65 days after that date) in order to reduce overall taxes.

Incomplete Non-Grantor Trusts. Taxpayers in high income tax states may be able to reduce their overall tax burden through the use of so-called "Delaware incomplete non-grantor trusts"

("**DING trusts**"), which are incomplete gift trusts established in a state that generally does not subject the income and capital gains of a non-grantor trust to state income tax (like Delaware, Nevada, Alaska, etc. (a "**no trust tax state**")). The plan typically involves an individual tax resident of a high-income tax state who transfers income-generating assets to an irrevocable trust domiciled in a no or low trust tax state. Depending upon the laws of the grantor's residence and the trust's domicile, the trust's income may not incur state income tax in either state (see prior *WRMarketplace* No. 13-14 for an additional discussion of DING trusts). Although a DING trust may subject more passive income to NIIT due to the lower threshold applicable to trusts, it may reduce or eliminate the state and local income tax component, and thus possibly reduce the overall tax burden.

Investment Portfolio Management. Another option for reducing NIIT exposure is to restructure the taxpayer's investment portfolio. For some clients, this may mean investing for growth rather than income (as with large cap dividend paying stocks), thereby deferring NIIT until securities are sold. For other clients, this may mean shifting investments into tax-free bonds with the goal of decreasing overall taxes and increasing after-tax income.

Charitable Remainder Trusts. For the client who anticipates selling a large, highly appreciated asset and is charitably inclined, an *inter vivos* charitable remainder trust may be an attractive option to reduce or eliminate both NIIT and capital gains tax on the sale. A charitable remainder trust is a special type of trust that pays an annuity or unitrust payment to a non-charitable beneficiary (usually the donor and/or his spouse) for a given period of time (typically for the beneficiary's lifetime), with the remaining assets passing to charity on the death of the beneficiary. The Treasury Regulations specifically exclude charitable remainder trusts from NIIT,[15] allowing deferral of capital gains tax and NIIT on the sale of assets within the trust, along with income tax deferred growth on the proceeds. Although charitable remainder trusts are exempt from NIIT, annuity or unitrust distributions to the non-charitable beneficiary are not exempt, and, to the extent such distributions carry out investment income, the income will be included in the beneficiary's net investment income for purposes of NIIT. However, use of a charitable remainder trust, which is excluded from NIIT, coupled with tax-efficient investments like investing in tax-exempt bonds, may provide overall tax benefits.

TAKE AWAYS

- NIIT and higher income tax brackets create new opportunities for advisors to assist individuals and trustees with investments, compensation, and tax deferral arrangements. Planning to reduce taxes will require regular financial reviews, particularly for clients near the triggering income thresholds.

- In a high income tax rate environment, the appropriate tax treatment of life insurance products—typically without imposition of income tax on internal growth or on policy death benefits—will increase the attractiveness of these products.

- Higher income taxes and the NIIT likely will increase interest in deferred compensation planning for executives and higher wage earners, with corresponding opportunities for life insurance funding.

- The "fresh start" election available to clients under the final Treasury Regulations provides clients with a one-time opportunity to regroup their business activities to meet material participation requirements thereby potentially reducing NIIT and other taxes.

- Private placement annuities and life insurance may particularly appeal to clients and trustees with investments in hedge funds, commodity funds, or high-yield taxable bonds. These clients may see returns consistently taxed at the highest income tax rates but not receive distributions to offset their tax liability. Holding investments of this type through the investment account of a properly structured private placement product can defer the gain recognition and NIIT, and also avoid the potential for phantom income.

- Charitable remainder trusts are also a viable option for those clients who are charitably inclined and have a large and/or highly appreciated asset to sell. Charitable remainder trusts are excluded from NIIT, allowing deferral of both capital gains tax and NIIT on the sale of the asset, along with income tax deferred growth on the proceeds, until distributed to the beneficiary as part of an annuity or unitrust payment.

NOTES

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[1] Technically titled the "Unearned Income Medicare Contribution Tax," the NIIT was approved by Congress as part of the Health Care and Education Reconciliation Act of 2010 and became effective January 1, 2013.
[2] MAGI is generally adjusted gross income reported on line 37 of Form 1040, U.S. Individual Income Tax Return, increased by any foregn earned income exclusion under Code § 911.
[3] Note that the NIIT does not apply to individuals who are noncitizens, nonresidents of the U.S. (Code § 1411(e)), or to noncitizens who are dual residents and are able to claim the benefits of an income tax treaty with a foreign country (Treas. Regs. § 1.1411-2(a)(2))..
[4] Treas. Regs. § 1.1411-3(b)(i)(v).
[5] Treas. Regs. § 1.1411-3(b). Foreign estates and trusts also are not subject to NIIT, however, distributions of investment income to U.S. beneficiaries will be included in the beneficiary's calculation of net investment income (Treas. Regs. § 1.1411–3(e)(3)(ii) and § 1.1411–4(e)(1)(ii)).
[6] Code § 1411(c), Treas. Regs. § 1.1411-4.
[7] See, Treas. Regs. § 1.1411-4(f)(3)(iii).
[8] Treas. Regs. § 1.1411-1(d)(4).
[9] Treas. Regs. § 1.1411-4(g)(6).
[10] Treas. Regs. § 1.1411-4(g)(5).
[11] *Id*. at 8.
[12] Treas. Regs. § 1.1411-4.
[13] *Id*. at 8.
[14] Treas. Regs. § 1.469-11(b)(3)(iv).
[15] Treas. Regs. § 1.1411-3(b)(1)(iii).

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