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## Recent Developments & Tax Planning for High Income Taxpayers

Cameron N. Cosby

Brian J. O'Connor

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**RECENT DEVELOPMENTS &  
TAX PLANNING FOR HIGH INCOME  
TAXPAYERS**

**WILLIAM & MARY TAX CONFERENCE**

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**Cameron Cosby  
Hogan Lovells US LLP**

**Brian O'Connor  
Venable LLP**



## Summary of New or Increased Taxes

- Section 1411: New 3.8% net investment income tax.
- Additional 0.9% tax on wages or self-employment income above the "threshold amount."
- 39.6% rate on ordinary income for individuals above the "applicable threshold."
- 20% rate on long-term capital gains and dividends for individuals above the "applicable threshold."



## Other Changes for Individuals

- AMT relief
- Extension of exclusion from gross income of COD income on principal residence
- Extension of special rules for contributions of capital gains real property for conservation



## Certain Business Tax Extensions

- Low-income housing tax credit
- New markets tax credit
- 15-year recovery for:
  - qualified leasehold improvement property,
  - qualified restaurant property, and
  - qualified retail improvement property.
- § 179 small business expensing
- Reduced recognition period for S corp built-in gains tax
- Bonus depreciation



## Section 1411

- Taxpayers with incomes above certain thresholds now face a new 3.8% Medicare tax on their investment income.
- This new tax is historic in that it represents the first time in history that employment-type taxes have applied to investment income.
- The tax may increase the overall tax due on certain types of ordinary investment income to as much as 43.4%.



## Section 1411 (cont'd)

- New 3.8% tax will increase the overall tax due on capital gain income to 23.8%.
- New 3.8% tax will increase the overall tax due on unrecaptured Section 1250 capital gain to 28.8%.
- New 3.8% tax will increase the overall tax due on collectibles capital gain to 31.8%.
- The new tax will be subject to individual estimated tax provisions.
- No portion of the new tax will be deductible in computing any tax due under subtitle A of the IRC (relating to income taxes).



## Section 1411 (cont'd)

- Specifically, for individuals, the new tax applies to the lesser of (i) "net investment income" or (ii) the excess of "modified adjusted gross income" over a "threshold amount."
- For estates and trusts, the new tax applies to the lesser of (i) undistributed "net investment income" or (ii) the excess of adjusted gross income over the dollar amount at which the highest tax bracket for trusts and estates begins (currently \$11,950).





## Section 1411 - Terminology

- "Net investment income"
- "Threshold amount"
- "Modified adjusted gross income"



## Section 1411 – Terminology (cont'd)

- "Net investment income" means the (i) sum of (a) gross income from interest, dividends, annuities, royalties and rents (other than income from an "active" business for purposes of Section 469 [passive loss rules] unrelated to financial trading) (an "Active Business"); (b) gross income from a "passive" activity for purposes of Section 469 or a financial trading business; and (c) net gain attributable to the disposition of property other than property from an Active Business; over (ii) the deductions properly allocable to such gross income or gain.



## Section 1411 – Terminology (cont'd)

Net Investment income does not include:

- Active Business income
- Certain gain on the sale of an Active Business
- Distributions from qualified plans
- Income subject to self-employment tax
- Tax-exempt income (but reported gains in excess of the exclusion for principal residence sales under Section 121 could be taxed at 3.8%).
- Income earned by certain charitable trusts



## Section 1411 – Terminology (cont'd)

- "Threshold amount" means (i) \$200,000 for single individual taxpayers; (ii) \$250,000 for married individual taxpayers filing a joint return; (iii) \$125,000 for married individual taxpayers filing a separate return; and (iv) \$11,950 for estates and trusts (top income tax bracket in 2013).
- These amounts are not indexed. Thus, with inflation, more and more taxpayers will become subject to Section 1411.



## Section 1411 – Terminology (cont'd)

- "Modified adjusted gross income" means adjusted gross income increased by the excess of (i) the amount excluded under the Section 911 foreign earned income exclusion (the "Section 911 Exclusion"); over (ii) the amount of any deductions or exclusions disallowed due to the Section 911 Exclusion.



## Section 1411 – Application to Real Estate

### Real Estate Ventures

- As discussed above, Section 1411 includes rental income within the definition of net investment income.
- To determine whether Section 1411 will apply to rent derived from real estate, both the nature of the investment and the capacity in which the individual holds the investment must be analyzed. That is, Section 1411, will not apply if:
  - The income is derived in the ordinary course of a trade or business; and
  - The taxpayer is not passive with respect to the activity from which the income is derived.



## Section 1411 – Application to Real Estate (cont'd)

### Trade or Business Standard

- For purposes of Section 1411, the Proposed Regulations provide that the trade or business standard of Section 162 shall be applied.
- Supreme Court has stated two (2) requirements for an activity to constitute a trade or business under Section 162: (1) the activity must be conducted for profit; and (2) the activity must be engaged in with some regularity and continuity (even if not by the taxpayer personally).



## Section 1411 – Application to Real Estate (cont'd)

### Passive Activity

- A passive activity is a trade or business in which the taxpayer does not materially participate and this determination is made at the individual taxpayer's level.
- In the context of rental activities, the material participation standard may be difficult to overcome for many investors, as rental activities are treated as *per se* passive activities unless the taxpayer is a "real estate professional."





## Section 1411 – Application to Real Estate (cont'd)

### Rental Income of "Real Estate Professionals"

- To qualify, a taxpayer must meet the following requirements:
  1. more than half of personal services performed during a given year are in real property trades or businesses in which the taxpayer materially participates; and
  2. the taxpayer performs more than 750 hours of services during that year in real property trades or businesses in which he materially participates.
- Aggregation election should be considered to meet material participation in rentals – see grouping discussion in later slide.



## Section 1411 – Application to Real Estate (cont'd)

### Material Participation

- Material participation requires that the taxpayer be involved on a regular, continuous, and substantial basis in the activity.
- The Regulations under Section 469 interpret this standard by providing that a taxpayer must meet one (1) of seven (7) tests (three (3) in the case of limited partners in a partnership) in order to be considered to be materially participating in an activity.



## Section 1411 – Application to Real Estate (cont'd)

### Important Points

- Under the Proposed Regulations, a real estate professional who materially participates may still be subject to Section 1411 if his rental activities do not rise to the level of a trade or business.
- Income generated from working capital is treated as income not derived in the ordinary course of a trade or business.



## Section 1411 – Application to Real Estate (cont'd)

### Sale of Pass-Through Entities

- Generally, sale of an interest in a pass-through entity is not considered property held in a trade or business and, thus, would be included in definition of net investment income.
- Exception: Net investment income from the sale of an interest in a pass-through entity is limited to the net gain (loss) that would have been recognized by the transferor of the interest if the entity sold all of its assets (a deemed sale) at fair market value immediately before the disposition of the interest.
- What about inside/outside basis disparities that result in gain in excess of what the transferor would have recognized on a deemed asset sale by the entity?



## Section 1411 – Application to Real Estate (cont'd)

### Tiered Partnerships and REITs

- As income from working capital will likely be net investment income even for a real estate professional, it will be necessary to properly allocate deductions between gross income from rental activities and from investment of working capital, which may be more difficult in tiered structures.
- Use of a REIT will cause what otherwise may be income exempt from Section 1411 to be captured as dividends. To avoid this result, fund managers may wish to hold any carried interest directly in the entities below the REIT.



## Planning for Section 1411

### How Do You Become "Active"?

- Consider recharacterizing activities as "active", if possible.
- Consider combining activities to maximize potential for "material participation".
- "Grouping" decisions are normally irrevocable (absent material changes in fact), but IRS will allow changes in light of new tax.
- How does a trust "materially participate"?



## Planning for Section 1411 (cont'd)

### Shift Investment Income to Self-Employment Income

- Ordinarily, it would never make sense to intentionally take steps to classify income as employment or self-employment income
- However, because no portion of the new 3.8% will be deductible for income tax purposes and the employer portion (that is 1.45%) of employment or self-employment taxes will qualify for an income tax deduction; it actually may make sense in some cases to plan to have income qualify as employment or self-employment income.



## Planning for Section 1411 (cont'd)

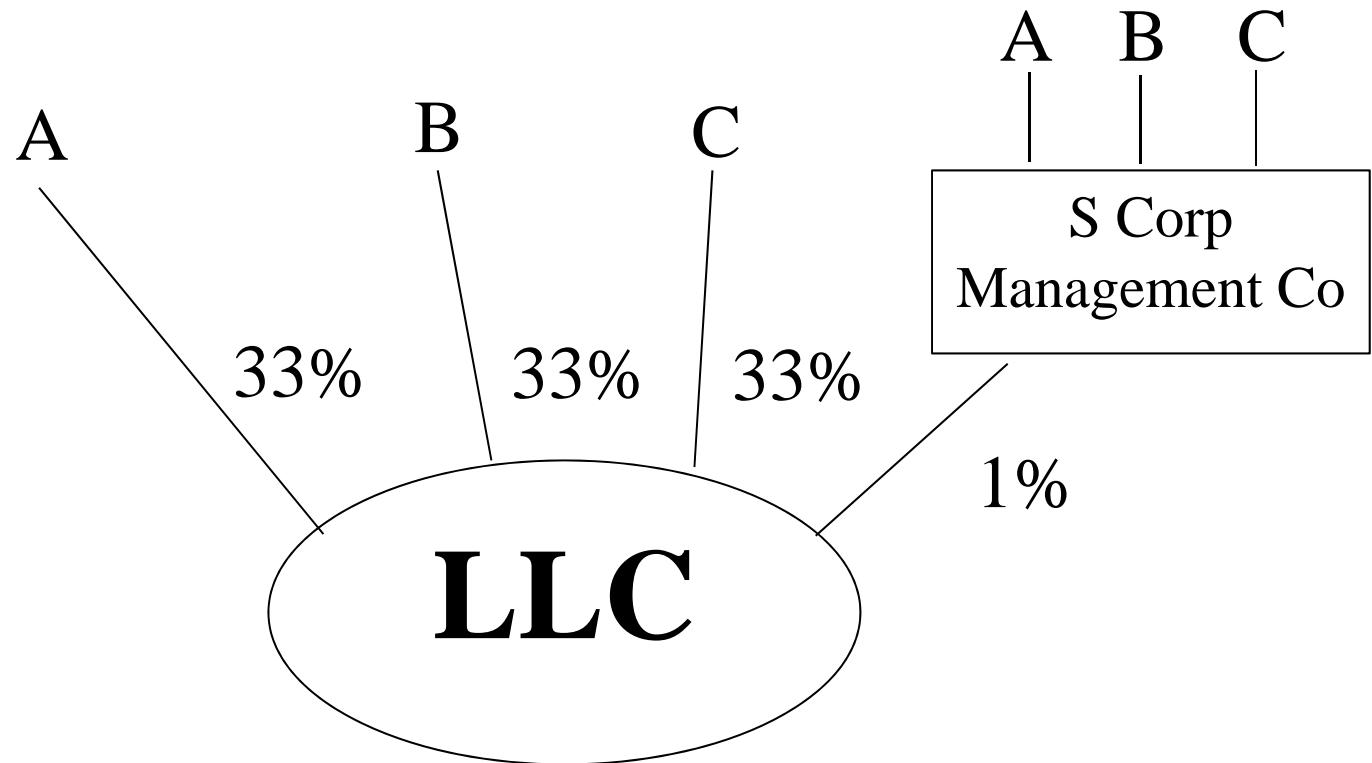
### Bifurcate Ownership in Partnerships

- For many years now, partners in certain partnerships have engaged in self-employment tax planning.
- Beginning in 2013, this planning may become more important for active partners.
- See next slides on structuring options.

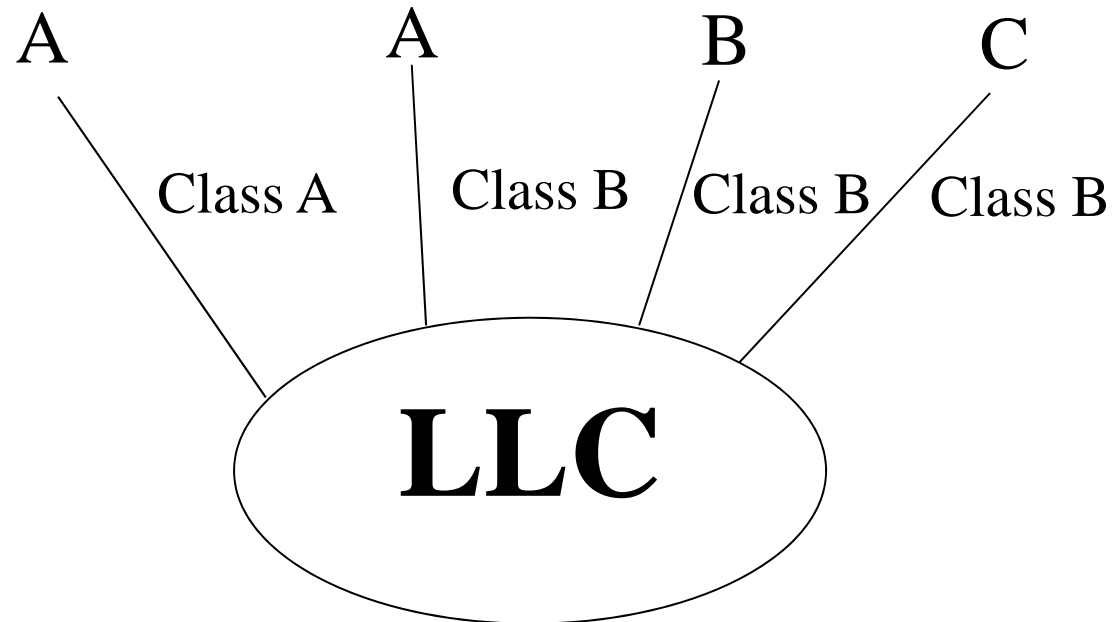




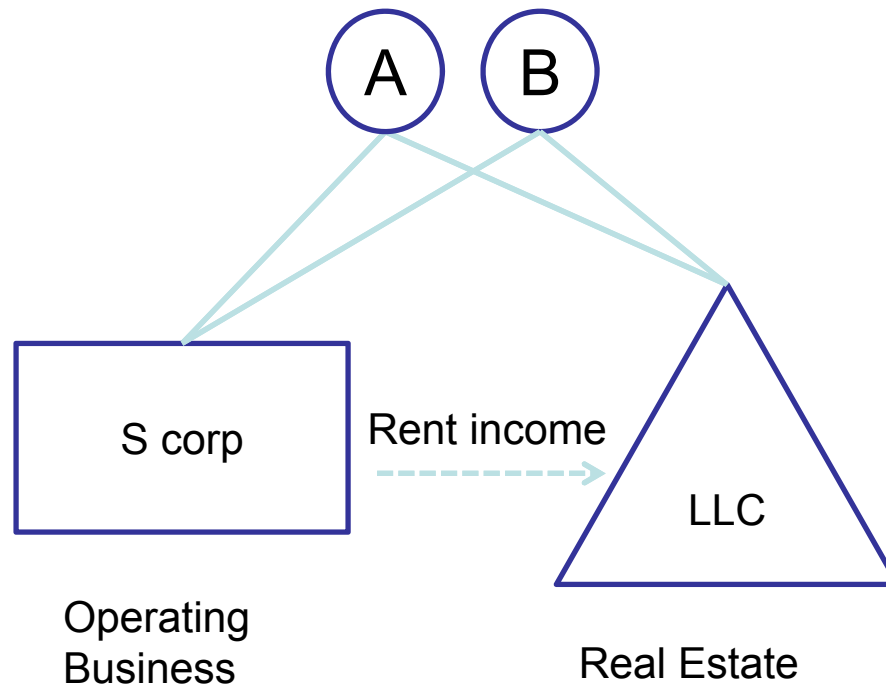
## Planning Structure #1 – S Corp Manager



## Planning Structure #2 – Multiple Classes



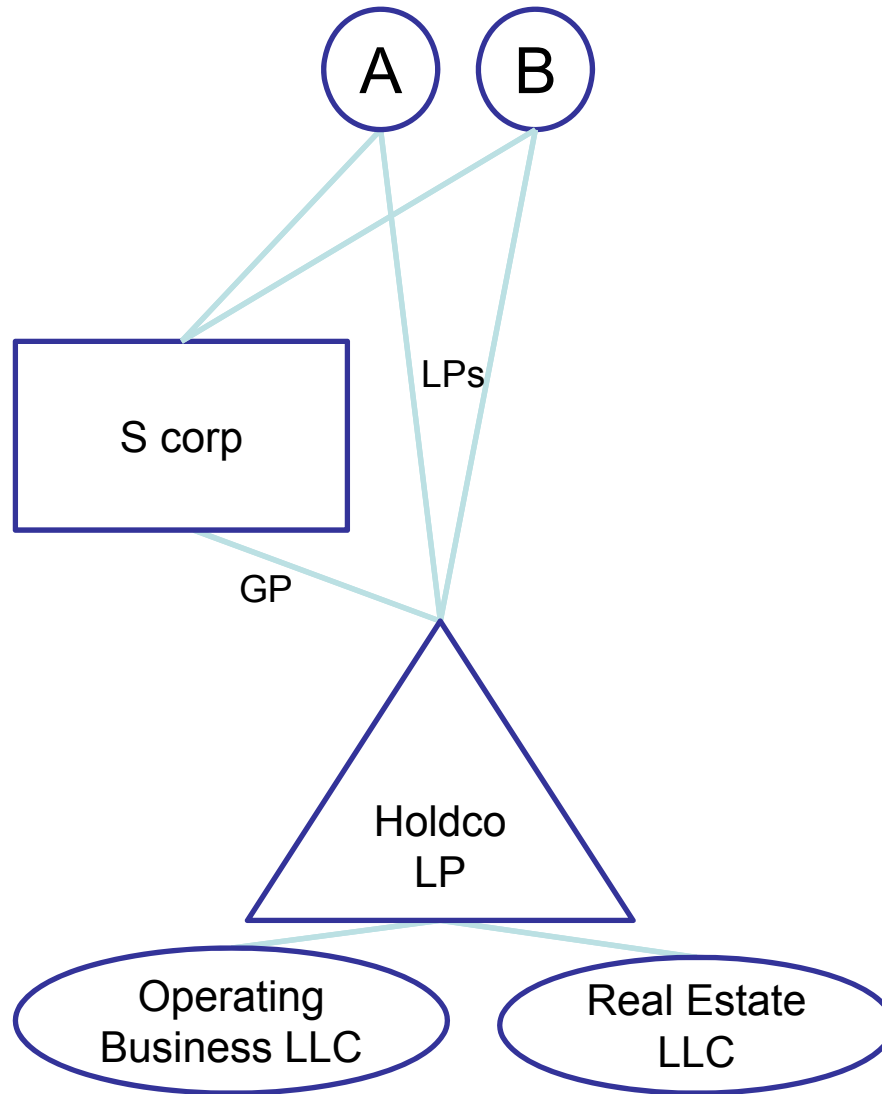
## Planning Structure #3 - Related Party Rent



Problem: § 469 self-charged concepts do not explicitly apply to trade or business requirement under § 1411, thus potentially causing the rent income to be subject to § 1411 if the real estate rental is not otherwise part of a § 162 trade or business.



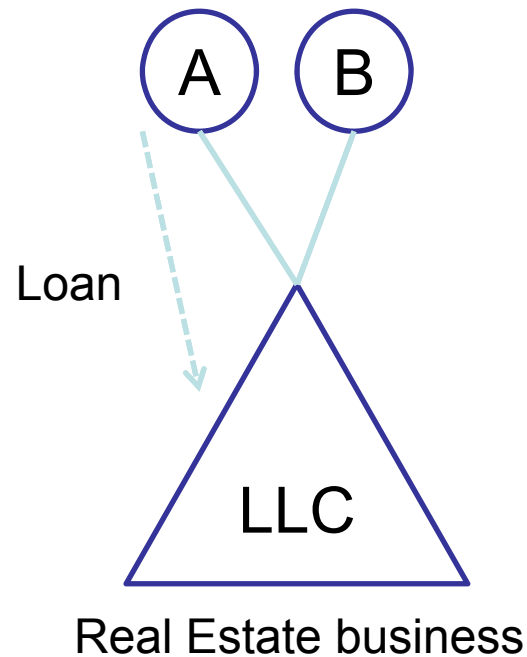
## Planning Structure #3 - Related Party Rent



Solution:  
Combine  
businesses so  
that rent income  
is instead a  
distributive share  
of combined  
operating income  
from an active  
business.



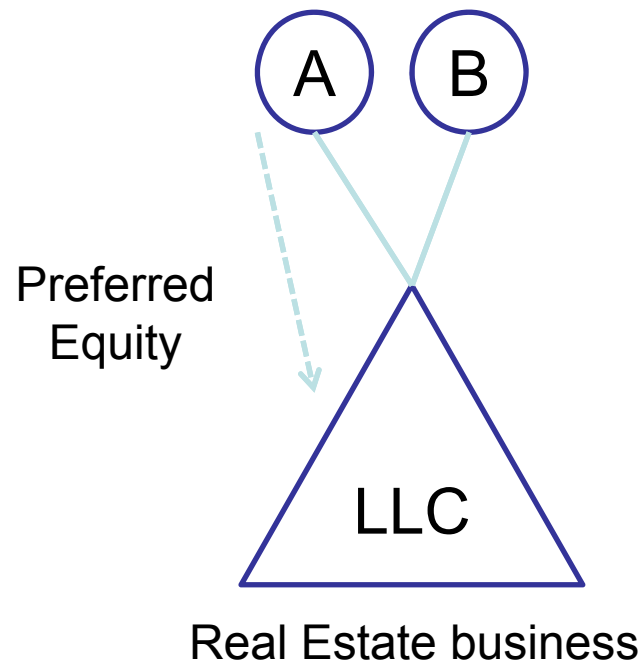
## Planning Structure #4 - Partner Loan



Problem: Loan creates interest income subject to § 1411. Even if § 469 self-charged concepts applied, that would only net A's interest income to the extent of A's share of interest expense.



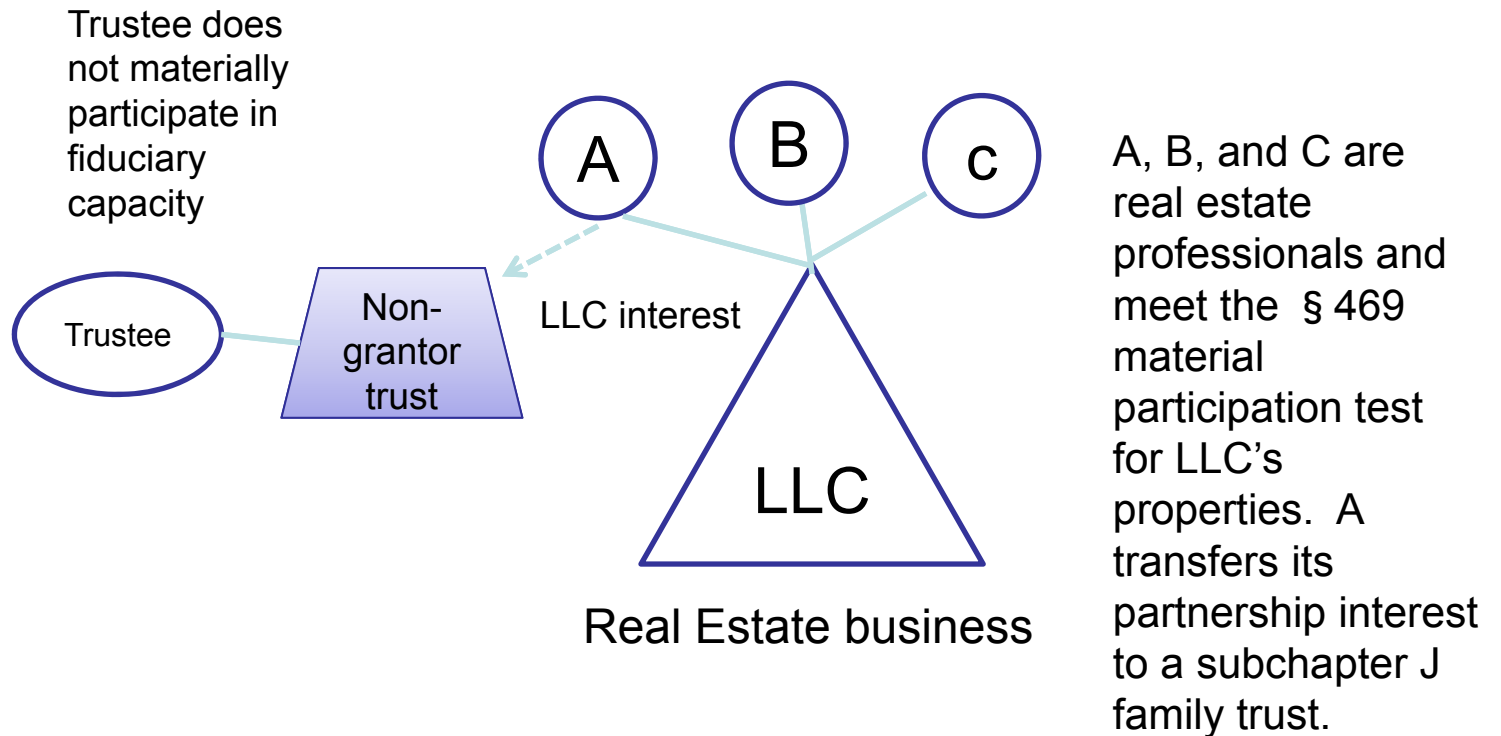
## Planning Structure #4 - Partner Loan



Solution: Change loan to preferred equity with § 704(b) allocation of income (for certainty, avoid § 707(c) guaranteed payment).



## Planning Structure #5 - Estate Planning

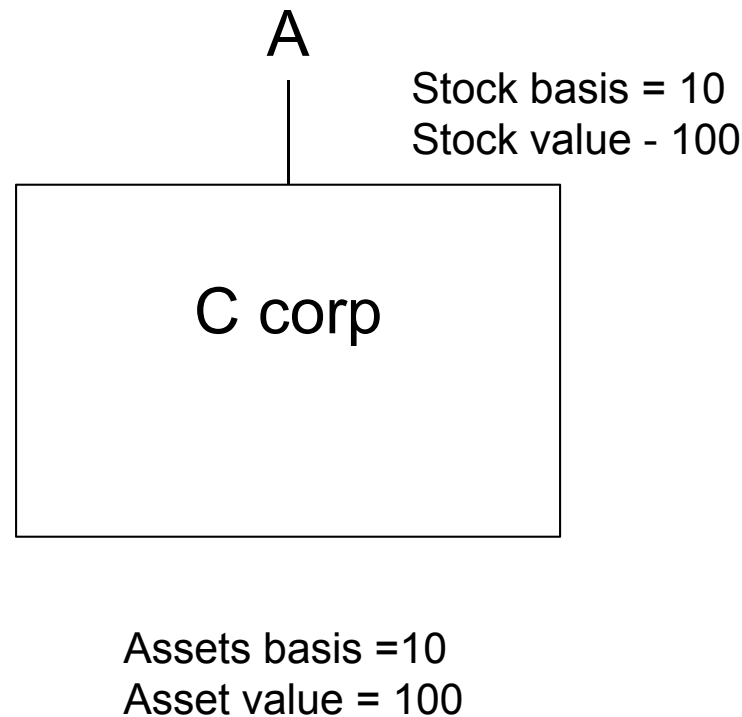


### RESULTS:

- (1) IRS position is that Trustee that does not materially participate except for direct services performed in a fiduciary capacity, effectively ensuring passive treatment and subjecting income/gain to 3.8% § 1411 tax. See TAM 201317010
  - (2) Taxpayer may argue Carter Trust case (looking to all activities of trust employees)
- PLANNING IDEA: Consider using intentionally defective grantor trust



## Planning Structure #6 – Corporate Stock Sale

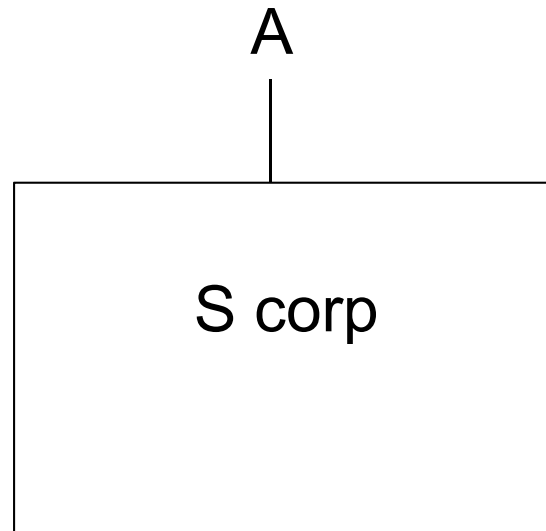


A owns 100% of C corp and has historically materially participated in C corp's business. A has agreed to sell stock of C corp to Buyer for cash. Absent § 1411 planning, the stock sale will generate a capital gain that will be subject to § 1411.





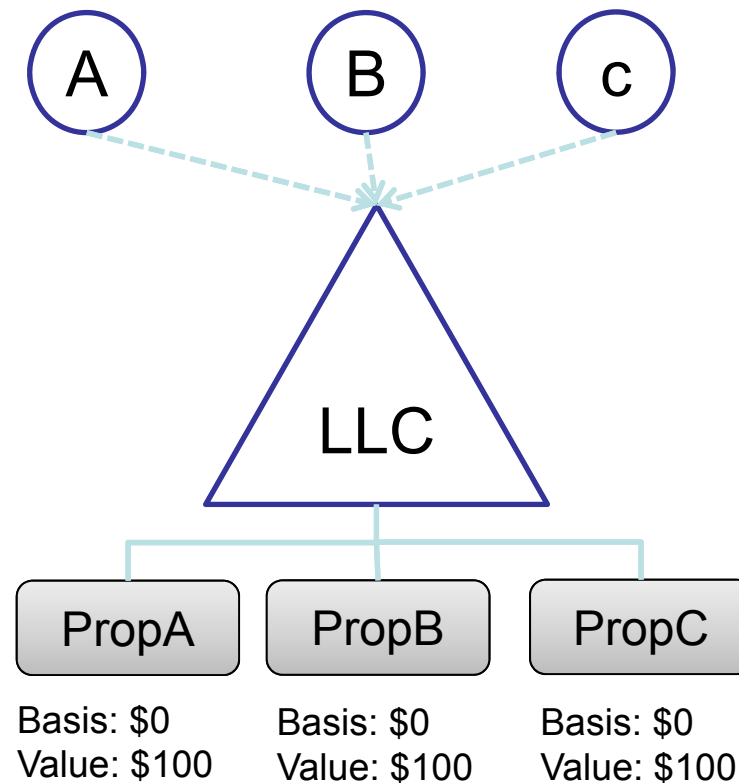
## Planning Structure #6 – Corporate Stock Sale



A elects S corporation status for C corp and then sells her stock after the effective date of the S election. As a result of this planning, stock sale may fall outside § 1411.



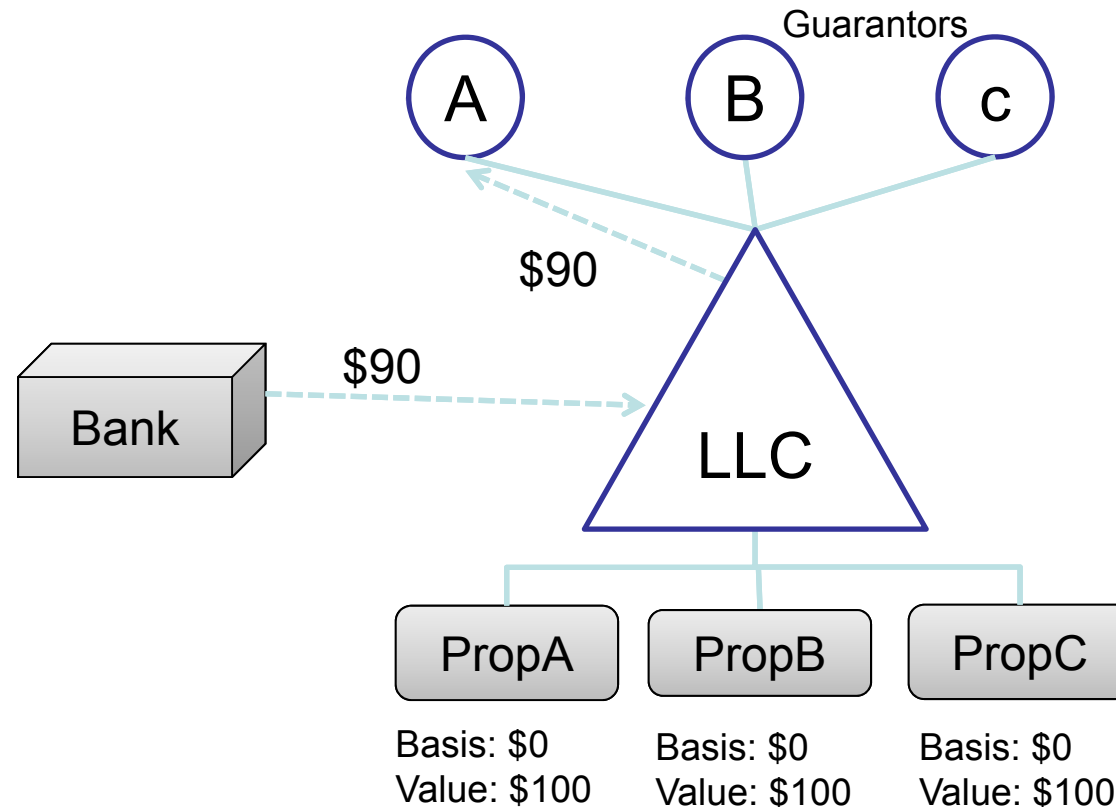
## Planning Structure #7 – Section 734(b) Mismatch



A, B and C are real estate professionals and meet the § 469 material participation test for LLC's properties. Each partner has \$100 of § 704(c) built-in gain from their contributed property.



## Planning Structure #7 - Section 734(b) Mismatch

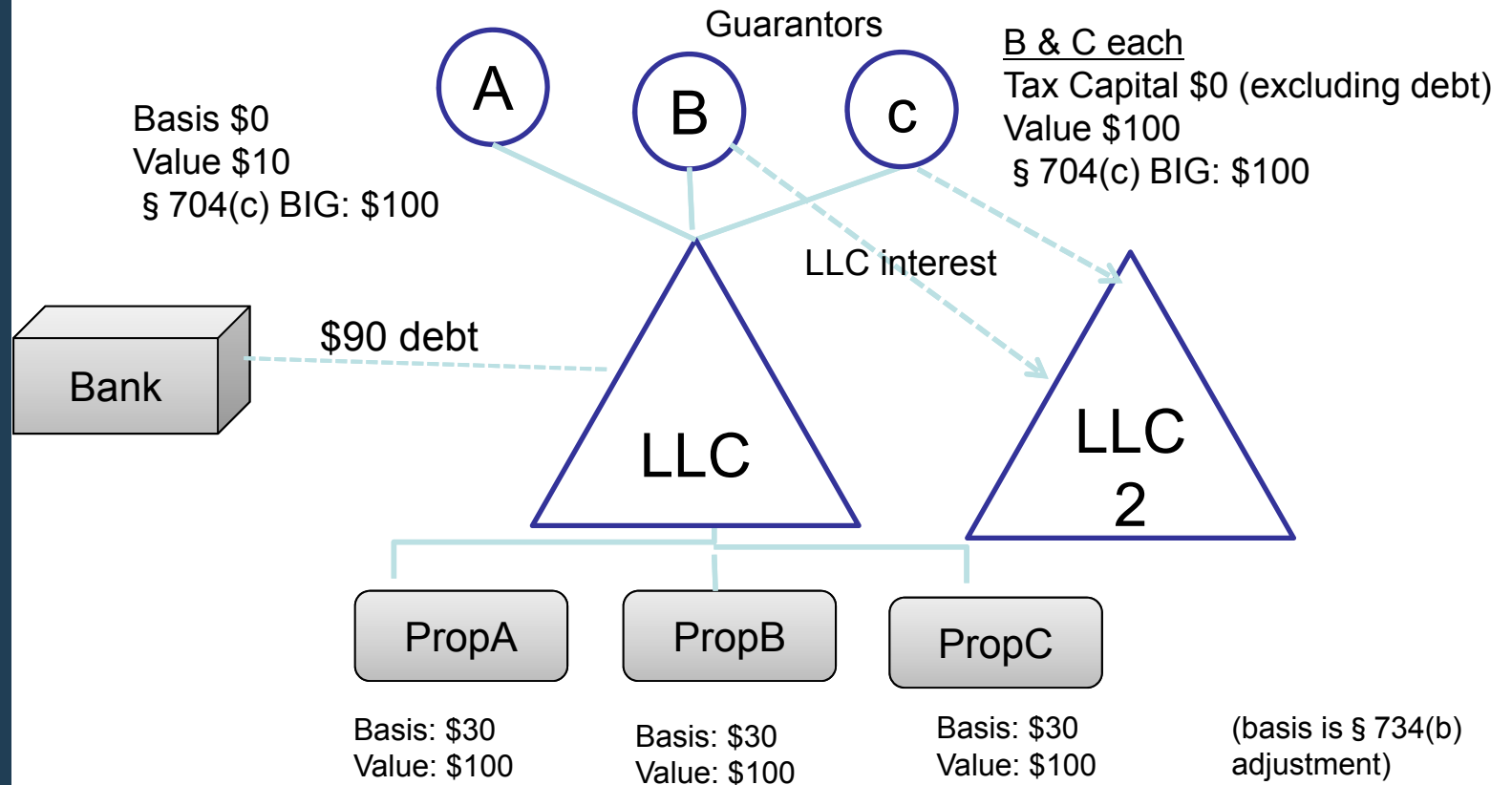


### RESULTS:

- (1) A recognizes \$90 of § 731(a) gain.
- (2) LLC has \$90 § 734(b) adjustment allocated \$30 to each property.
- (3) B and C are at risk for 3.8% tax on \$30 because § 734(b) adjustment reduced their inside gain by \$30 so now inside-outside gain disparity



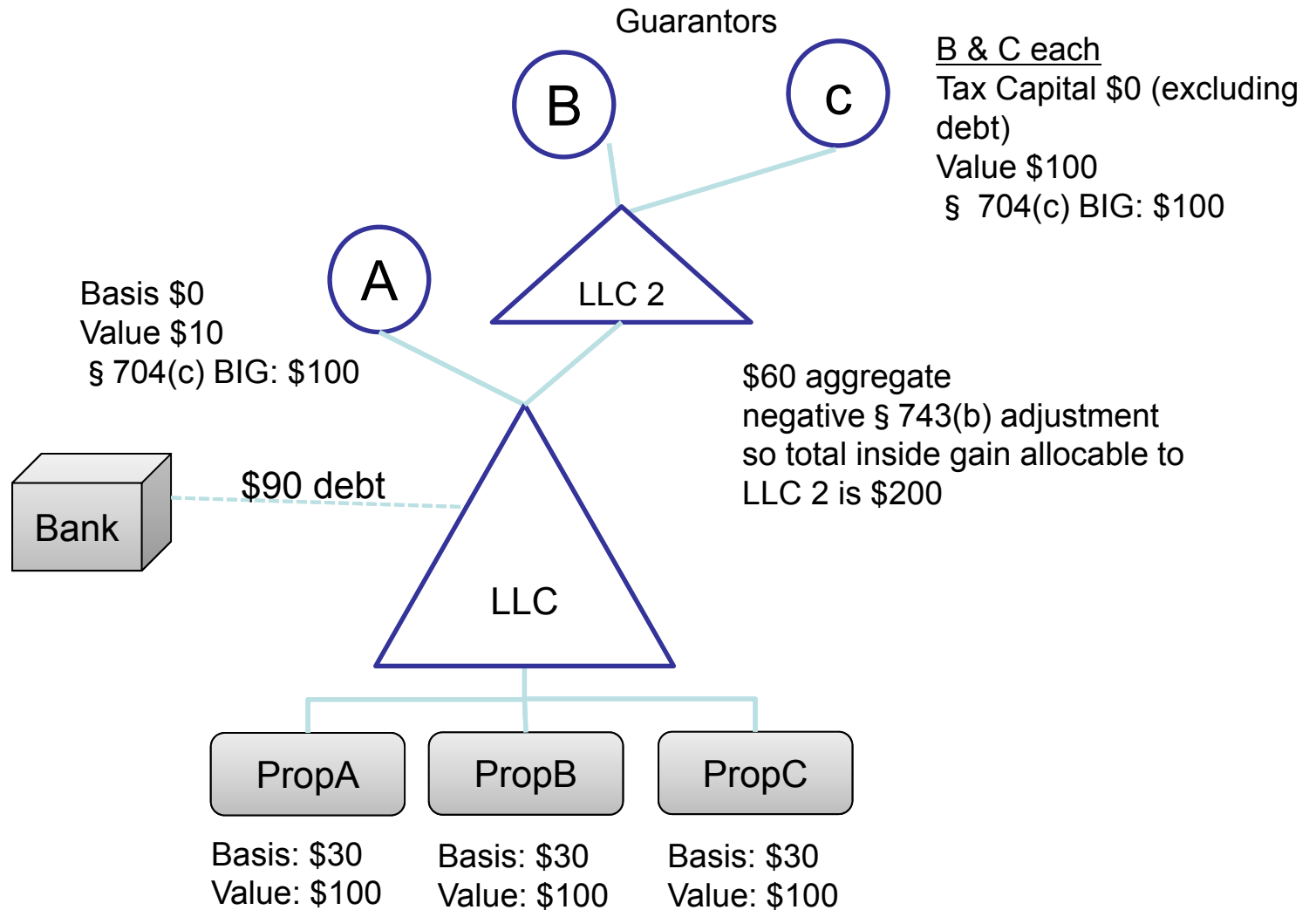
# Planning Structure #7 – Section 734(b) Mismatch Solution



Event: B and C transfer to lower-tier partnership and make § 754 election. This creates an offsetting negative § 743(b) adjustment to increase inside gain and maintain parity between B and C's higher outside gain and their inside gain.



# Planning Structure #7 - Section 734(b) Mismatch Solution



## Other Planning Considerations

- Grouping Activities
  - One-time ability to change grouping
  - Grouping has positive 1411 advantages but negative 469 consequences when considering partial dispositions
- Estate Planning and Valuation Discounts
- Prior events where chose not to make Section 754 election to avoid inside basis step down



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## FOR FURTHER INFORMATION

Brian O'Connor  
Venable  
Baltimore, MD/Washington,  
DC/Tysons Corner, VA  
410-244-7863  
[bjconnor@venable.com](mailto:bjconnor@venable.com)

Cameron Cosby  
Hogan Lovells US LLP  
Washington, DC  
202-637-3681  
[cam.cosby@hoganlovells.com](mailto:cam.cosby@hoganlovells.com)



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