Net Investment Income Tax Planning

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Section 1411

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AGENDA

- FICA and SECA
- NET INVESTMENT INCOME TAX
  - OVERVIEW
  - ELEMENTS OF AN EXCLUDED BUSINESS
  - LOSSES AND DEDUCTIONS
  - SPECIAL SITUATIONS
THE 3.8% TAX

INCOME

SERVICES

INVESTMENTS

SECA & FICA

(NET INVESTMENT INCOME)
FICA & SECA
Subtitle C imposes Employment Taxes:

- Federal Insurance Contribution Act (FICA)
- Railroad Retirement Tax Act (RRTA)
- Federal Unemployment Tax Act (FUTA)
- Federal Income Withholding Taxes

Employment taxes are imposed on both the "employer" and the "employee"
Income from Self Employment
Section 1402

- Generally, gross income of an individual –
  - Derived from any trade or business carried on by such individual (less allowed deductions)
  - The individual’s distributive share of income or loss from any trade or business carried on by a partnership of which he is a member.

- Partners are not treated as employees; partners are generally subject to SECA unless exempt under section 1402(a)(13)
  - Section 1402(a)(13) provides that distributive share of partnership income or loss of a limited partner (other than guaranteed payments for services) is excluded from “net income from self employment”
  - Employee income is excluded from SECA
Exclusions from Net Income from Self Employment

- Rents from real estate and from personal property leased with the real estate
- Dividends & interest (unless received in the course of a trade or business as dealer)
- Gain or loss from sale or exchange of
  - A capital asset
  - Cutting of timber or disposal of timber, coal, iron ore if section 631 applies
  - Sale, exchange, involuntary conversion or disposition of property that is not inventory-type or dealer property
Exclusions from Net Income from Self Employment (cont'd)

- Distributive share of a limited partner other than a guaranteed payment for services
- Distributive share of an S corporation shareholder
- Wages
- Certain retirement payments to partners
- Gross income from the business of trading
What Is a “Limited Partner”? 

Options to Improve Tax Compliance and Reform Tax expenditures, prepared by the Staff of the Joint Committee on Taxation, January 27, 2005 (JCS-02-05) at 100:

The reference in the self-employment tax rules to ‘limited partners’ does not reflect changes in State limited partnership laws permitting individuals designated as limited partners under State Law to perform management services as well as other services for the partnership. The present-law rule limiting the amount of self-employment tax of a limited partner to the amount of guaranteed payments does not treat partners performing services comparably, and should be conformed to the rule for general partners.
Limited Partners' distributive share?

What if the Limited Partner materially participates in business?

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Section 1411
Net Investment Income Tax
Health Care Act of 2010 Changes
Effective after 12/31/2012

• Health Insurance (HI) Tax – Individuals
  – Employees: increased employee’s share by .9% (total of 3.8%) on earnings in excess of “threshold amount”
  – Self-employed: increased HI tax by .9% (total of 3.8%) on net SE income in excess of “threshold amount”

• NII Tax – Individuals, Estates & Trusts
  – Tax of 3.8% on “net investment income” (NII) in excess of “threshold amount” of individual or “undistributed NII” of estate or trust
• **Individuals**
  - $250,000 Married filing jointly
  - $125,000 Married filing separately
  - $200,000 Other

• **Estates & Trusts (Nil Tax only)**
  - Level at which top rate applies
  - $12,150 (2014)
- Section 1411 imposes a 3.8% tax on the lesser of an individual's:
  - Net Investment Income (NII) or
  - Modified Adjusted Gross Income in excess of a Threshold Amount

- Law effective for tax years beginning after 12/31/2012.
  - Proposed regulations published in December 2012.
  - Regulations published December 2013, with new Proposed Regulations.
Net Investment Income – A Two-step Determination

THE SUM OF:

Gross Income from -
- Interest
- Dividends
- Royalties,
- Annuities, and
- Rents

Other Gross Income derived in -
- A passive trade or business
- The trade or business of trading in financial instruments or commodities

Net Gain from the disposition of Property-
- Other than property held in a trade or business not described in Bucket 2.

Unless derived in a trade or business not described in Bucket 2.

LESS: the deductions allowed by the subtitle which are properly allocable to such gross income or net gain.
### Income Not Subject to the Net Investment Income Tax

<table>
<thead>
<tr>
<th>Income / Gain of Nonresident Aliens</th>
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<tr>
<td>Distributions from Qualified Plans</td>
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<td>Ordinary course, non-passive, trade or business income (that is not the business of &quot;trading&quot;): an Excluded Business</td>
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Once Gross Income and Net Gain is allocated to the Buckets, it is reduced by allowable deductions that are "properly allocable" to such gross income.

- Deductions must be currently allowable.
  - Must clear loss disallowance rules including section 704(d), 465, 469, capital loss carryforward, 163(d)(1), 67, 68, etc.
- Some Net Operating Loss (NOLs) are allowed.
- Exception for deductions that have reduced SECA.
- Properly allocable deductions include "excess losses" (allowable losses in excess of gains in Bucket 3)
  - Losses can reduce Bucket 3 gains only to the extent of such gain.
  - Excess losses are properly allocable deductions.
  - Note that for section 475 Traders, mark-to-market gains and losses are included in Bucket 3; for other Traders, capital gains/losses in Bucket 3; for both excess losses are properly allocable deductions.

Nil cannot be negative
Elements of an Excluded Business
What Is an Excluded Business?

An Excluded Business is

(1) A trade or business activity (other than the business of trading financial instruments or commodities)
(2) That is not a passive activity.
What is the Business of Trading?

Includes both mark-to-market and non-mark-to-market trading

If the activity is owned through a partnership or S corporation:
Determination is made at the entity level as to whether the income is from a trade or business of trading in financial instruments or commodities, and the distributive share of income retains its character as it passes through to the taxpayer.

Compare investing and dealing
Definitions for the Trade or Business of Trading

- **Financial Instruments:**
  - Stocks and other equity interests
  - Evidences of indebtedness
  - Options
  - Forward or futures contracts
  - Notional principal contracts
  - Any other derivatives
  - Any evidence of an interest in any of the above items (including short positions or partial units)

- **Commodities:**
  - Items described in section 475(e)(2)
Section 951 and section 1293: Inclusions on stock of controlled foreign corporation ("CFC") or qualified electing fund ("QEF") held as part of a Section 1411 trade or business are included in NII as of the date included for purposes of chapter 1:

- Trading
- Dealer activity which is passive to taxpayer

Otherwise inclusion is included in NII when taxpayer receives distribution of previously taxed income (PTI), unless "-10(g) election" is made.

- Must make adjustments to basis and modified AGI to reflect non-inclusion for NII purposes
- Once made, election is irrevocable
- Must be considered on an activity-by-activity basis
Passive Activity Loss Rules – Overview

A passive activity is—

- A trade or business activity in which the taxpayer does not materially participate and
- Most rental activities
Section 469 divides income into three categories:

1. **Nonpassive** - 
   Income from activities in which the taxpayer materially participates, including activities in which wages or salaries are earned.

2. **Passive** - 
   Income from activities in which the taxpayer does not materially participate and 
   Income that is *per se* passive

3. **Portfolio** – 
   Investment income such as annuities, royalties, interest, dividend, capital gains/losses, guaranteed payments for interest on capital.
Define Portfolio Income for Purposes of Section 469

The Section 469 regulations classify the following as portfolio income (Listed Income) –

- Interest, annuities royalties, dividends on C corp stock
- Income from a REIT, RIC, REMIC
- Income from a common trust fund, controlled foreign corporation, qualified electing fund, or coop
- Dividends on S corp stock
- Income from the disposition of property that produces the type of income listed above, and
- Income from the disposition of property held for investment within the meaning of section 163(d).
- UNLESS such gross income is derived from a trade or business for purposes of Section 469 as follows…
Derived from a Trade or Business for Purposes of Section 469

The following are selected trade or business activities that may produce the listed income treated as trade or business income –

- Interest income on loans and investments made in the business of lending;
- Interest on accounts receivables arising in the ordinary course of selling property or providing services, but only if credit is customarily offered to customers;
- Income from investments made in the ordinary course of the business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity is a trade or business (but see exclusion if dealer ever held as an investment);

- Note oil & gas royalty dealer example in regulations.

Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangibles.

- See sec. 1.469-2T(c)(3)(iii)(B).
The section 469 regulations (sec. 1.469-4(b)(1)) provide that the following are treated as a trade or business: activities that –

- Involve the conduct of a trade or business under section 162 (See Groetzinger v. Commissioner, 480 US 23 (1987));
- Are conducted in anticipation of the commencement of a trade or business; and
- Involve research or experimental expenditures that are deductible under section 174.

See also Sec. 1.469-9(b)(1), which provides that any interest in rental real estate, including an interest that gives rise to sec. 212 deductions, may be a trade or business.

See exception.
What is a Rental Activity for Purposes of Section 469?

An activity is a rental activity if tangible property held in connection with the activity is used by customers or held for use by customers; and

The gross income attributable to the conduct of the activity represents (or will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use is pursuant to a lease or pursuant to a service contract or other arrangement that is not called a lease).

Deductions can be under section 212 or section 162.
Rental activities for section 469 do not include the following:

1. Short-term rentals where the average use is 7 days or less
2. Rentals where the average use is 30 days or less and there are significant personal services
3. Rentals that involve extraordinary personal services (rental incident to services)
4. Incidental rentals
5. Nonexclusive use by customer
6. Property provided to certain flow-through entities
Passive Activity Loss Rules – Why is it Important to Define the Activity?

Level of participation determined for each activity

May be easier to meet material participation standard if separate undertakings are combined.

Suspension loss allowed upon the disposition of all or substantially all of activity

May be easier to free up losses if separate undertakings have not been combined as one activity

Passive loss and credit carryovers are tracked separately for each activity
Generally, an activity is one or more business undertakings

- Several business undertakings that together form an appropriate "economic unit" may constitute an activity, or
- A segregated business undertaking may itself constitute an activity

Determined based on all facts and circumstances; factors taken into account include –

- Common control, common ownership, geographical location, similarity of business, interdependence.
Restrictions on Grouping

Certain activities of limited partners and limited entrepreneurs (applies to motion pictures, farming, leasing, oil and gas, geothermal deposits)

Personal property rentals cannot be grouped with real estate rentals

Rental activities with trade or business activities unless—

- Rental is insubstantial in relation to trade or business or vice versa or
- The rental and the trade or business have the same proportionate ownership – and then only with respect to the rental income paid by the trade or business
Passive Activity Loss Rules – Limitations on Grouping Activities

Section 469 entities (partnerships, closely held C corp, S corp)
Must perform the first grouping of the entity’s activities
Taxpayers cannot treat activities grouped together by the Section 469 entity as separate, but may group that activity with other activities of taxpayer
Passive Activity Loss Rules –
Grouping Consistency Requirement

Taxpayer may not regroup activities in subsequent years unless the original grouping was clearly inappropriate or there has been a material change in facts.

Commissioner may regroup if taxpayer’s groupings fail to reflect appropriate economic units and primary purpose was to circumvent section 469.
Section 1411 Grouping Fresh Start

Individuals, estates and trusts may regroup activities for both section 469 and 1411 purposes (under the rules of section 469) –

In the first year that section 1411 would apply in the absence of a regrouping.

Can regroup in 2013 if eligible or in 2014 if eligible – but not both years.

No second chance:

- Once have used the fresh start regrouping, cannot regroup for section 1411 purposes again.

- If fail to regroup in the first year (2014 et seq) that section 1411 would apply; no opportunity to regroup in the future.

Special rules apply for adjustments to income, erroneous regrouping, and so on.

Individuals: For tax years beginning on or after January 25, 2010, Rev. Proc. 2010-13 requires written annual return disclosures:

1. In the first year in which two or more passive activities are grouped as a single activity.

2. In a year in which a passive activity is added to the grouping.

3. In a year in which the taxpayer determines that the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate.

However, a partner or S corporation shareholder need not make any additional disclosures with respect to a section 469 entity's activity unless the partner/shareholder groups the section 469 entity's activities that were not grouped by the entity, or groups an activity of the section 469 entity with other activities conducted directly (or indirectly through other section 469 entities).
Section 469 Entities: Annual activity grouping disclosures required in accordance with the instructions for Forms 1065 and 1120S.

- Fresh start for section 1411 not available for 469 entities

Forms require separate activity reporting – 17 items required for each activity.

Does reporting net income/loss on Schedule K, Line 1 amount to a “grouping” or not?
Grandfather Rule for individual taxpayer groupings prior to the effective date of Rev. Proc. 2010-13 need not be disclosed unless the individual taxpayer –

• Adds a new passive activity to the group;
• Determines that the original grouping was clearly inappropriate; or
• Determines there has been a material change to the facts and circumstances that makes the original grouping clearly inappropriate.

Grandfather rule does not appear to be applicable to partnership disclosures.
If a taxpayer fails to disclose a grouping that is required to be disclosed under Rev. Proc. 2010-13, each trade or business will be treated as a separate activity (unless the IRS regroups under anti-avoidance rule of Treas. Reg. section 1.469-4(f)).
Passive Activity Loss Rules: What Does it Mean to Participate?

Regular, continuous, and substantial involvement

Generally, any work in an activity done by an individual who owns an interest in the activity
- Includes spouse’s participation

Exceptions
- Work not customarily done by owners if principal purpose is avoidance of section 469
- Work done as an investor, unless involved in daily operations
Passive Activity Loss Rules –
Does Taxpayer Materially Participate?

There are seven tests for material participation for non-limited partners:

1. Taxpayer participated more than 500 hours
2. Taxpayer participation was substantially all of the hours
3. Participation was >100 hours and more than anyone else
4. Taxpayer's participation in “significant participation activities” exceeded 500 hours
5. “Nickel and dime test” (materially participated 5 of last 10 years)
6. Personal service activity (any 3 years)
7. Facts and circumstances test (and > 100 hours)
Limited partners determine material participation using three of the tests:

1. Taxpayer participated more than 500 hours
2. "Nickel and dime test" (materially participated 5 of last 10 years)
3. Personal service activity (any 3 years)

If limited partner also owns a general partner interest, limited partner is treated as general partner

LLC members are generally not limited partners for this purpose.

See such cases as Garnett and Thompson and proposed regulations under section 469.
Passive Activity Loss Rules- 
Recharacterization of Net Income

Gains from formerly nonpassive activities
Rental of "nondepreciable" property
Equity-financed lending activity
Licensing intangible property
Net income from rental incidental-to-development
Net rental income from rental to a nonpassive activity of the taxpayer
Significant participation passive activities ("SPPA")
Taxpayer participates more than 100 hours in each of several trade or business activities but does not materially participate in any of the trade or business activities and total hours do not exceed 500 hours.

If passive gross income from all significant participation passive activities exceeds passive activity deductions from all such activities, a portion of the net passive income is treated as nonpassive.
Passive Activity Loss Rules - “Real Estate Professional” Exception

If a taxpayer qualifies as a “real estate professional:”

- Rental real estate activities are not *per se* passive

  and

- The taxpayer can elect to group all rental real estate activities as a single activity for purposes of qualifying as materially participating in the rental activity. The election applies for all years in which the taxpayer is a real estate professional.

  *If the grouping election is not made, each rental is treated as a separate activity.*
Two-pronged test (each prong having sub-tests):

1. More than ½ of personal services performed in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates; 
and

2. Such taxpayer performs more than 750 hours of services in real property trades or businesses in which taxpayer materially participate
Real Property Trade or Business: any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.


Just because real property is involved, isn't necessarily a real property trade or business. Owning and operating an inn? A hotel? An apartment building?

Closely held C corp is in a real property trade or business if more than 50% of gross receipts are derived from real property trades or business in which the corporation materially participates.

Services performed by an employee are not performed in real property trades or businesses unless performed by a 5% owner in the employer.

The taxpayer (without counting spouse’s hours) must materially participate in real estate trades or businesses for the required number of hours,

If the real estate trade or business is rental, it must qualify as a rental activity (real estate rented for more than 7 days on average) and the taxpayer must establish material participation in the rental activity, and

An activity of leasing real estate for 7 days or less on average is not treated as a real estate trade or business for this purpose.

Importance of election to treat all rental activities as a single activity for purposes of material participation test. See e.g. Miller v. Commissioner, T.C. Memo. 2011-219.
If a taxpayer lends money to a partnership or S corp in which the taxpayer owns an interest, or vice versa, the taxpayer will have interest income and expense related to the loan. If the proceeds of the loan are used in a passive activity, there could be a mismatch between the passive deductions generated and the portfolio interest income from the loan. These are “self-charged” interest deductions that the regulations intend to allow to offset. The regulations also apply to guaranteed payments for the use of capital under section 707(c).

The regulations recharacterize the “applicable percentage” of the interest income and/or the interest expense as arising from a passive activity.

- See Treas. Reg. section 1.469-7 for calculations and examples.
A lends money to a partnership (PRS) in which A owns a 50% interest.

PRS pays A $5,000 interest and allocates $2,500 to A as an interest expense deduction allocable to a passive activity in Yr 1.

A’s applicable percentage of the interest income is 50% and $2,500 of A’s interest income is recharacterized as income from a passive activity.

The balance of the interest income is portfolio income.
Passive Activity Loss Rules –
Former Passive Activities

Losses from former passive activities may offset only income from the former passive activity. The remaining suspended loss is allowed if the taxpayer disposes of the activity in a fully taxable transaction to an unrelated person.

According to the House Committee Report, Revenue Reconciliation Act of 1993, if a taxpayer has a suspended passive loss (e.g. from rental activities) and qualifies as a real estate professional, the suspended loss is treated as a loss from a former passive activity.

Other situations include:
- Contribution of the passive activity to a corporation.
- Closely held C corp no longer subject to section 469.
- The taxpayer now materially participates in the activity.
- Formerly rented property is untenanted and held for investment.
LOSSES AND DEDUCTIONS
Properly Allocable Deductions – Under the Final Regulations

- General chapter 1 tax principles apply for determining the amount and timing of the deductions.

- Only amounts paid or incurred by a taxpayer to produce the gross income included in NII may be deducted in determining NII.

- NII may not be less than zero – Any otherwise unused allocable deductions not taken into account in the year incurred are not carried forward to offset future NII.
  - Unless included in an NOL carryforward
Properly Allocable Deductions – Under the Final Regulations – cont’d

- **Section 165 Losses**: Losses (allowed under chapter 1) that exceed gains from dealing in property are properly allocable deductions – to the extent not taken into account in computing the amount of “net gain” included in NII.
  - **For example**, if the taxpayer has capital losses in excess of gain on disposition of property that is treated as NII, the $3,000 allowed under section 1211(b) may be used to reduce NII as a properly allocable deduction.

- **NOLs**: Total “section 1411 NOL amount” is a properly allocable deduction.
Several itemized deductions are properly allocable deductions:
- Investment interest expense
- Investment expenses
- State and local, and foreign, income, war profits, and excess profits taxes
- Foreign tax expenditures if not claiming a foreign tax credit

The Final Regulations provide that Treasury may publish additional guidance that expands the list of properly allocable deductions.

Other properly allocable deductions from NII include:
- Items described in sections 72(b)(3) and 691(c)
- Items described in section 212(3) to extent allocable to NII
- Amortizable bond premium
- Fiduciary expenses to extent allocable to NII
- Ordinary loss deductions for contingent payment debt instrument or inflation-indexed debt instrument
Timing and Carryovers

- **Timing**
  - Unless provided otherwise, gain not recognized in a particular year under chapter 1 is not recognized for that year for purposes of section 1411. Examples include:
    - Section 453 (installment sales)
    - Section 1031 (like-kind exchanges)
    - Section 1033 (involuntary conversions)
    - Section 121 (sale of principal residence)

- **Deferral and disallowance provisions used in determining taxable income apply in determining NII**
  - Section 163(d) (limitation on investment interest)
  - Section 265 (expenses and interest relating to tax-exempt income)
  - Section 465 (at risk limitations)
  - Section 469 (passive activity loss limitations)
  - Section 704(d) (partner loss limitation)
  - Section 1366 (S corporation shareholder loss limitations)
  - Section 1212 (capital loss carryover limitations)
Timing and Carryovers – cont’d

- Carryovers
  - Allowed for determining NII in the same year as allowed for AGI
  - Whether or not carried from a year that precedes the effective date of section 1411
  - 2013 Proposed Regulations provide for an adjustment to exclude capital losses that are derived from property held in a non-designated trade or business

- NII may be reduced by a portion of the net operating loss carryforward

Final regulations provide for a complex calculation that allows use of all or a portion of the NOL carryforward
Preserve the rule (in the 2012 Proposed Regulations) that all capital losses incurred prior to 2013 and carried forward to 2013 and subsequent years are available to offset NII.

Provide a mechanism for adjusting capital losses incurred in 2013 and subsequent years for “excluded capital loss” (defined as capital losses attributable to the disposition of property used in a trade or business that is not a designated trade or business).

- Prop. Reg. section 1.1411-4(d)(4)(iii) creates an annual adjustment mechanism to capital loss carryforwards for purposes of NII.
For each NOL carried to and deducted in the current taxable year:

1. Determine the “applicable portion” of the NOL – which is the lesser of
   a) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine NII and only properly allocable deductions are taken into account in determining the NOL in accordance with section 172(c) and (d) or
   b) The amount of the NOL for the loss year.

2. Multiply the amount of the NOL carried from each loss year and deducted in the taxable year by the following fraction:

   The “applicable portion” of the NOL = the “Section 1411 NOL Amount” the total NOL for the loss year.

- The sum of Section 1411 NOL Amounts for each NOL carried to and deducted in the taxable year equals the total section 1411 NOL amount that is a “properly allocable deduction” for purposes of calculating NII.
SPECIAL SITUATIONS
DISPOSITIONS OF PARTNERSHIP INTERESTS AND S CORPORATION STOCK
Net Gain on Disposition

- NII includes gains from dispositions of partnership interests or S corporation stock when the partnerships or S corporations have no assets held in the ordinary course of an Excluded Business.
  - The 2012 Proposed regulations included a complex calculation to determine the amount of gain included in NII. The Final Regulations withdrew these provisions.

- The 2013 Proposed Regulations include simplified rules available to certain taxpayers for calculating the amount of NII on disposition of an interest in a passthrough entity.
**Section 1411 Property** is property that, if sold, would result in net gain or loss included in determining NII.

**Section 1411 Holding Period** means the year of disposition and the transferor’s two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less, including the period held by others in certain circumstances (generally nonrecognition transactions).

**Passthrough Entity** means a partnership or S corporation.
2013 Proposed Regulations – Section 1411 Dispositions

The 2013 Proposed Regulations apply only to transfers by individuals, estates and trusts of an interest in a Passthrough Entity that is engaged – or owns a subsidiary Passthrough Entity that is engaged – in one or more trades or businesses that is not a Section 1411 Trade or Business (Section 1411 Disposition)

Special rule that applies to a Section 1411 Disposition:
If a fully taxable disposition of all the Passthrough Entity’s assets is followed by a complete liquidation of the Passthrough Entity, the disposition is treated as an asset sale for purposes of section 1411 and no additional gain or loss from the liquidation is included in NII
If the transferor recognizes gain on the disposition, the amount of gain included in NII is the lesser of –

- The transferor’s gain on the disposition under chapter 1 or
- The transferor’s allocable share of the chapter 1 net gain from a deemed sale of the Passthrough Entity’s Section 1411 Property determined using the principles of section 1.469-2T(e)(3)

If the transferor recognizes a loss on the disposition, the amount of loss included in NII is the lesser of –

- The transferor’s loss (expressed as a positive number) on the disposition of the interest in the Passthrough Entity or
- The transferor’s allocable share of the chapter 1 net loss (expressed as a positive number) from the deemed sale of the entity’s Section 1411 Property as determined in accordance with section 1.469-2T(e)(3)
The amount of net gain or loss included in NII from the transferor’s disposition is determined by multiplying the transferor’s chapter 1 gain by a fraction:

The numerator of the fraction is the sum of income, gain, loss, and deduction items of a type taken into account as NII allocated to the transferor during the Section 1411 Holding Period.
The denominator of which is all income, gain, loss and deduction allocated to the transferor during the Section 1411 Holding Period.
Transferor must satisfy one of the following:

1. During the Section 1411 holding period, the transferor’s share of separately stated income, gain, loss, and deduction included in NII is 5% or less of the transferor’s total share of items from the partnership and the total chapter 1 gain recognized on the disposition does not exceed $5 million or

2. The total amount of chapter 1 gain or loss does not exceed $250,000.
The Simplified Method is not available if any of the following conditions exist:

• The transferor has held the interest in the Passthrough Entity for less than 12 months
• The transferor transferred Section 1411 Property to the Passthrough Entity or received a distribution of property (other than Section 1411 Property) during the Section 1411 Holding Period as part of a plan that includes the disposition. Transfers within 120 days of the disposition are presumed to be part of a plan.
• The transferor’s share of partnership items is not a proportionate share
• The transferor knows or has reason to know that the Passthrough Entity’s Section 1411 Property has changed by 25% or more during the transferor’s Section 1411 Holding Period
• The Passthrough Entity was a C corporation during the Section 1411 Holding Period and elected to be treated as an S corporation.
CFCs and QEFs
**Different inclusion timing depending on activity:**

- If inclusion derived in a section 1411 business, inclusion constitutes NII when included in income under Chapter 1.
  - Trading
  - Dealer activity which is passive to taxpayer
- Otherwise inclusion is included in NII when taxpayer receives distribution of previously taxed income (PTI), unless "-10(g) election" is made.
  - Must make adjustments to basis and modified AGI to reflect non-inclusion for NII purposes.
The -10(g) election is generally a partner-level election for 2013.
- Passthrough entity may make election for 2013 if unanimous consent is received from all partners (including indirect partners).

- Passthrough entity may make election for tax years beginning after December 31, 2013. Unanimous partner consent not required after 2013.

- The -10(g) election is time sensitive – it must be made no later than first year taxpayer subject to section 1411 and has an inclusion from the QEF/CFC.
  - Can be made in advance; can be made on amended return.
  - Is an entity-by-entity election.
Special rules if there is an inclusion in 2013 and there is no -10(g) election made for 2013, but there is a -10(g) election made for 2014:

- Partnership must track actual distributions from QEF/CFC which generated the 2013 inclusion.
- Any actual distributions of PTI that are made subsequent to 2013 are treated as being made first from the 2013 PTI, to the extent of the 2013 inclusion.
- Such amounts are treated as dividends for purposes of section 1411, notwithstanding the in force -10(g) election.
Schedule K-1 Reporting Requirements

- If no 10(g) election in effect and the partnership is not engaged in a section 1411 trade or business, the partnership must provide the following information for each entity if not otherwise on the Schedule K-1:
  - Section 951(a) inclusions
  - Section 1293(a)(1)(A) inclusions
  - Section 1293(a)(1)(B) inclusions
  - Section 959(d) distributions subject to section 1411
  - Section 1293(c) distributions subject to section 1411
  - Amount of gain or loss derived with respect to dispositions of the stock of CFCs and QEFs
  - Amounts that are derived with respect to the disposition of the stock of CFCs and QEFs and included in income as a dividend under section 1248 for section 1411 purposes.
• If a 10(g) election is in effect, and the partnership is not engaged in a section 1411 trade or business, the partnership must provide the following information on an entity-by-entity or on an aggregate basis, if not otherwise on the K-1:
  - Section 951(a) inclusions
  - Section 1293(a)(1)(A) inclusions
  - Section 1293(a)(1)(B) inclusions
Schedule K-1 Reporting Requirements – cont’d

- If the partnership is engaged in a section 1411 trade or business, the partnership must provide the following information on an entity-by-entity or on an aggregate basis, if not otherwise on the K-1, or may aggregate this information with other income that is Nil from a Section 1411 Business:
  - Section 951(a) inclusions
  - Section 1293(a)(1)(A) inclusions
  - Section 1293(a)(1)(B) inclusions
Schedule K-1 Reporting Requirements – cont’d

- For mark-to-market (under section 1296) PFICs directly or indirectly owned by the partnership, the partnership must provide the following information (if not otherwise identifiable elsewhere in the K-1) on either an entity-by-entity or aggregate basis or may aggregate this information with other NII from a section 1411 trade or business owned by the partnership:
  - Amounts included in income under section 1296(a)(1)
  - Amounts deducted from income under section 1296(a)(2)
If the partnership owns PFIC stock directly or indirectly with respect to which direct or indirect partners are subject to section 1291, the partnership must provide the following information (if not otherwise identifiable on the K-1):

- Excess distributions made by a PFIC with respect to which a partner is subject to section 1291
- Gains derived with respect to the disposition of stock of a PFIC with respect to which a partner is subject to section 1291
ILLUSTRATIVE EXAMPLES
**Distributive Share of Partnership Trade or Business Income**

<table>
<thead>
<tr>
<th></th>
<th>SECA</th>
<th>NIIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>General PRS</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>Limited PRS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GP</td>
<td>Y</td>
<td>N</td>
</tr>
<tr>
<td>LP</td>
<td>N</td>
<td>?*</td>
</tr>
<tr>
<td>LLC **</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>LLP ***</td>
<td>Y</td>
<td>N?</td>
</tr>
</tbody>
</table>

* No NIIT if LP can “materially participate” under section 469 and remain an LP

** No SECA if LLC member qualifies as a “limited partner” under 1997 Prop. Reg.
   - No power to contract/does not work 500 hours
   - Hard to avoid NIIT if qualify as “limited partner” under 1997 Prop. Reg.

*** Renkemeyer court treated LLP as general partnership with limited liability; in other circumstances, a passive investor could be subject to NIIT rather than SECA

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Employment Taxes
A & B perform services for S corp
- FICA, no SECA

Net Investment Income Tax
1) PRS Trade or Business (Not Trading)
   Non-passive               NII? No
   Passive                  NII? Yes
2) PRS Trading Business
   A, B, LP                NII? Yes
3) PRS Investments
   A, B, LP                Gain
   Income                 NII? Depends
                           NII? Depends
Private Equity Funds

MGMT Co

Individuals
NII

GP

Carry

PE Fund

Individual Investors
LPs
NII

Investments

Fee Income
- If SECA, no NII
- If not SECA, not NII if materially participate
NII Tax Planning Considerations

Consider income on the Schedule K-1: interest, dividends, royalties, rents, annuities
- Consider whether generated by a trade or business activity
- Consider definition of “rent” and whether passive under section 469

Grouping choices for trade or business activities
- Documentation for material participation

One set of recharacterization rules – treated as non-passive for NII
- Incidental to development
- Significant participation passive activity
- Rental to a related non-passive activity

Second set of recharacterization rules – remain passive for NII
- Rental of nondepreciable property
- Equity financed lending
- Licensing intangible property

Disposition timing
Questions?

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