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# Plotting a Path through the Net Investment Income Tax Maze

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# Application of NIIT

- 3.8% tax imposed on net investment income (NII)
- For individuals (not trusts and estates), NIIT is 3.8% of the lesser of:
  - NII
  - Excess of modified adjusted gross income over
    - \$200,000 if single
    - \$250,000 if married and filing jointly



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# Application of NIIT

- NII is imposed under § 1411
- Imposed in addition to regular and AMT taxes
- Not reduced by credits such as foreign tax credit or general business credits
- NIIT liability is subject to estimated taxes
- Included for purposes of understatement penalties, return preparer penalties and interest on under/overpayments



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# Definition of NII

- Category 1 – income not derived in ordinary course of business
- Category 2 – other gross income derived from a trade or business that is
  - A passive activity
  - Trading in financial instruments or commodities
- Category 3 – net gains from the disposition of property



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# Definition of NII

- Excluded Income
  - Income excluded by § 1411 statute
  - Income excluded from federal tax base
  - Income that is not NII



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# Category 1

- Income not derived in the ordinary course of business
  - Interest, dividends, rents, royalties and annuities
- Ordinary course of trade or business exception
  - Derived in trade or business that is not
    - Passive activity
    - Trading in financial instruments or commodities
  - Derived in “ordinary course”



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## Category 2

- Other gross income derived from a trade or business that is
  - A passive activity
  - Trading in financial instruments or commodities
- Engaged in trade or business of trading financial instruments or commodities
  - Only if classified as a “dealer” or “trader”
  - Not an “investor”



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## Category 3

- Net gains from the disposition of property
  - Other than property held in a trade or business that is not a passive activity or trading business
- Income tax rules determine when there has been a disposition for NII purposes
- Net gains may not be less than zero
  - But § 165 losses in excess of gains allowed as “properly allocable deduction”
- Loss ordering rule



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# Properly Allocable Deductions

- General income tax principles apply
- Only amounts paid or incurred to produce income or net gains may be deducted
- Deductions cannot exceed NII
  - Possible carry over
- If deduction is not explicitly enumerated in NIIT regulations, then it is not deductible



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# Trusts and Estates

- NIIT imposed on trusts and estates on lesser of
  - Undistributed NII
  - Excess of AGI over dollar amount where highest bracket begins
- Determination of undistributed NII
- Specifically excluded trusts



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# Passive Activities

- NII includes “other gross income” (Category 2) from a trade or business that is a passive activity
- Determination of a passive activity
  - Individuals
  - Pass-through entities
- Material participation requirements



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# Activity Grouping

- Taxpayers may aggregate multiple activities into a single activity
  - Material participation is tested at activity level
  - Activity grouping must be an “appropriate economic unit”
- Regrouping for NII purposes



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# Suspended Losses

- Income and loss from passive activities are netted
- Passive activity loss is suspended and not currently deductible
- Formerly passive activities
- Disposition of passive activity



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# NII and Rental Real Estate

- NII generally includes rental income
- NII does not include
  - Rental income derived in ordinary course of a nonpassive trade or business
  - Gain or loss on disposition of rental property used in a nonpassive trade or business
- Real estate professionals



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# Disposition of Interest in S Corporation or Partnership

- Proposed regulations provide two methods for determining net gains subject to NIIT
  - Primary method
  - Optional simplified method
- Information reporting on Form 8960