Top Federal Tax Issues

FOR 2014 | CPE COURSE

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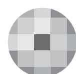

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TOP FEDERAL TAX ISSUES FOR 2014 CPE COURSE

Introduction

Each year, a handful of tax issues typically require special attention by tax practitioners. The reasons vary, from a particularly complicated new provision in the Internal Revenue Code, to a planning technique opened up by a new regulation or ruling, or the availability of a significant tax benefit with a short window of opportunity. Sometimes a developing business need creates a new set of tax problems, or pressure exerted by Congress or the Administration puts more heat on some taxpayers while giving others more slack. All these share in creating a unique mix that in turn creates special opportunities and pitfalls in the coming year and beyond. The past year has seen more than its share of these developing issues.

CCH's *Top Federal Tax Issues for 2014 CPE Course* identifies those recent events that have developed into the current "hot" issues of the day. These tax issues have been selected as particularly relevant to tax practice in 2014. They have been selected not only because of their impact on return preparation during the 2014 tax season but also because of the important role they play in developing effective tax strategies for 2014 and beyond. Some issues are outgrowths of several years of developments; others have burst onto the tax scene unexpectedly. Among the latter are issues directly related to the recent economic downturn and tax legislation designed to assist in a recovery. Some have been emphasized in IRS publications and notices; others are just being noticed by the IRS.

This course is designed to help reassure the tax practitioner that he or she is not missing out on advising clients about a hot, new tax opportunity; or that a brewing controversy does not blindside their practice. In addition to issue identification, this course provides the basic information needed for the tax practitioner to implement a plan that addresses the particular opportunities and pitfalls presented by any one of those issues. Among the topics examined in the *Top Federal Tax Issues for 2014 CPE Course* are:

- IRS Gears Up for Health Care Reform
- Net Investment Income Tax: Issues and Strategies
- Implementing Accounting Method Changes
- Income Tax-Deferral Techniques
- Innocent Spouse Relief
- Identity Theft: Due Diligence and Remedies
- Boomer Retirement Strategies
- FATCA: New Rules for International Disclosure and Account Reporting
- Public Charities and Private Foundations: Current Compliance Issues

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MODULE 1: HEALTH CARE LAW: NEW REQUIREMENTS — CHAPTER 1

IRS Gears Up for Health Care Reform

Health care reform was enacted in 2010 to expand the provision of health insurance to more Americans. Reform comprises two major laws: the *Patient Protection and Affordable Care Act* (PPACA), and the *Health Care and Education Reconciliation Act* (HCERA). Although some provisions of these laws took effect in the years 2010–2013, two important provisions will not take effect until 2014: the individual mandate and the premium tax credit. Another major provision—the employer mandate—was scheduled to take effect in 2014, but the IRS effectively delayed it until 2015. The IRS and other federal agencies (notably the Departments of Labor and Health and Human Services (HHS)) have been issuing important guidance on health care reform. This chapter reviews some of the important tax provisions in PPACA, including these three major provisions, and the IRS guidance.

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LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Discuss some of the continuing legal challenges to PPACA since the 2012 Supreme Court decision;
- Describe the requirements for the individual mandate (individual shared responsibility payment);
- Identify the requirements for the employer mandate (employer shared responsibility payment);
- Determine the eligibility requirements for the health insurance premium assistance tax credit;
- Understand the role of affordable health insurance exchanges;
- Explain other important provisions of PPACA, such as the rules for wellness programs; and
- List and describe important revenue-raising provisions in PPACA, including the tanning services excise tax; the branded prescription drug fee; the medical device excise tax; and the tax on health insurance providers.

INTRODUCTION

PPACA is a lengthy and complex law, with many requirements and features. The IRS has been issuing detailed guidance since the law's enactment in 2010. Some of the law's complexity reflects the law's jumble of effective dates, but by 2014, most of the major provisions of the law will have taken effect, except for the employer mandate and the tax on "Cadillac" health plans. Most individuals and employers are affected by these provisions. They

include the *individual mandate* (individual shared responsibility payment), which requires most individuals and their families to carry health insurance or face a penalty; the health insurance premium assistance tax credit, which the IRS will administer to help low- and middle-income Americans pay for health insurance; and the *employer mandate* (employer shared responsibility payment), which requires most employers to provide essential, affordable health insurance coverage or face a penalty.

SHARED RESPONSIBILITY FOR INDIVIDUALS

Beginning in 2014, PPACA requires individuals to:

- Be covered by a health plan that provides basic health insurance coverage (known as *minimum essential coverage* or MEC);
- Qualify for an exemption from the coverage requirement; or
- Pay a shared responsibility payment.

This shared responsibility provision for individuals is also known as the *individual mandate.*

COMMENT

PPACA gives "shared responsibility" to improve access to health insurance to the federal government, state governments, insurers, employers, and individuals. Nevertheless, the government, citing Congressional Budget Office research, claims that less than 2 percent of Americans will owe a shared responsibility payment.

The provision applies to individuals of all ages, including children and other dependents. U.S. citizens living in the United States or abroad are covered by the requirement, but U.S. citizens living abroad for the entire year are treated as having MEC and therefore do not owe a payment. Foreign nationals who live in the U.S. long enough to qualify as resident aliens are covered. Residents of U.S. territories are treated as having MEC.

The adult or married couple who can claim a dependent is held responsible for making the payment if the child or dependent adult does not have coverage or an exemption. A married couple is jointly liable for the payment. Under the proposed regulations, a taxpayer is liable for an individual who may be claimed as a dependent, whether or not the taxpayer actually claims the dependent.

COMMENT

Who should be responsible for children's coverage is an issue for divorced couples and other adults. Commentators have noted that a divorced noncustodial parent who cannot claim the exemption may be ordered to pay for health insurance for a child, but the current rules hold the custodial parent liable for the payment.

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The individual mandate applies on a monthly basis. The amount of the payment is based on the number of months in the calendar year that an individual lacks MEC or an exemption. Under the proposed regulations (NPRM REG-148500-12), an individual is treated as having MEC for the month if the individual is covered for at least one day during the month.

Minimum Essential Coverage

An individual who is covered by health insurance that provides MEC will not owe the payment. MEC includes the following:

- Coverage under a specified government-sponsored program;
- Coverage under an eligible employer-sponsored plan, including COBRA continuation coverage and retiree health coverage;
- Coverage under a health plan offered in the individual market;
- Coverage under a grandfathered health plan; and
- Other health benefit coverage recognized as MEC by the Treasury Department and HHS.

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Government programs. Government-sponsored programs that provide MEC include Medicare, Medicaid, the Children's Health Insurance Program (CHIP), the TRICARE program, veterans' health care programs, coverage for Peace Corps volunteers, and certain coverage provided by the Defense Department. The proposed regulations exclude certain programs with limited coverage from MEC. These are similar to programs providing excepted benefits.

Employer programs. An eligible employer-sponsored plan is a group health plan or group health insurance coverage. *Group health plans* include both third-party insured health plans and self-insured health plans. Most employer-provided coverage will qualify as MEC. If an employee enrolls his or her family in an employer-sponsored plan, the covered family members will have MEC.

Marketplaces. The federal government encourages individuals who lack coverage, who may discontinue current coverage, or who may want to look for cheaper coverage, to go to a health insurance marketplace (also known as an *affordable insurance exchange*). These are established at the state level either by the state government or by the federal government acting in place of the state. The federal government advises that marketplaces will help individuals find affordable MEC and can determine whether the individual will qualify for financial assistance, such as the health insurance premium tax credit.

Excepted benefits. MEC does not include coverage that consists of certain excepted benefits, including:

- Accident and disability coverage;
- Supplemental coverage to liability insurance;
- Liability insurance;
- Workers' compensation;
- Automobile medical payment insurance;
- Credit-only insurance;
- Coverage for on-site medical clinics; and
- Other similar insurance coverage under which medical benefits are secondary or incidental to other insurance benefits.

Other excepted benefits are not MEC if offered under a separate policy:

- Long-term care;
- Limited dental and vision benefits;
- Coverage for a disease or specified illness;
- Hospital indemnity or other fixed indemnity insurance; and
- Medicare supplemental health insurance.

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Required Contribution

The proposed regulations reiterate that MEC is not affordable if the individual's required contribution (on an annual basis) exceeds 8 percent of the taxpayer's household income for the year. For an individual with employer coverage, the test applies to the cost of the lowest self-only coverage. However, for a related individual eligible for employer coverage, the proposed regulations apply the affordability exemption by looking at the employee's required contribution for the cost of family coverage.

Under the proposed regulations, the taxpayer's household income must be increased by any portion of the required contribution made under a salary reduction arrangement. After 2014, this 8 percent figure will be increased by the excess of the rate of premium growth between the preceding year and 2013, over the rate of income growth for the same period, as determined by HHS.

Health plans are categorized by level (bronze, silver, gold, or platinum), based on their actuarial value, which is the percentage of the plan's share of the full actuarial value of the benefits provided under the plan. The actuarial values are as follow:

- For a bronze plan, 60 percent;
- For a silver plan, 70 percent;
- For gold, 80 percent; and
- For platinum, 90 percent.

For individuals not eligible for employer-sponsored MEC, the minimum required contribution is the premium for the lowest cost bronze plan offered

in the health insurance exchange, reduced by the maximum amount of any premium assistance credit, determined as if the individual were covered by a qualified health plan through the exchange for the entire year

EXAMPLE

The annual premium for the lowest cost bronze plan offered by the exchange is $10,000. Based on his family size and income, Elliot Campbell, a married taxpayer, would be entitled to a credit of $3,100. Elliot's required contribution is $6,900. His household income is $80,000 for the year. The coverage is not affordable because the required contribution ($6,900) exceeds 8 percent of his household income ($6,400). Therefore, he is not liable for the individual shared responsibility payment.

The proposed regulations clarify that if both members of a couple are eligible for employer-sponsored coverage, each individual determines the affordability of coverage using the premium for self-only coverage offered by the individual's employer. Neither individual may use the premium for family coverage. As a result, the IRS stated, each employed individual's self-only coverage may be treated as affordable, even though the aggregate cost of covering all employed individuals may exceed 8 percent of the family's household income. HHS is proposing rules to provide a hardship exemption in these circumstances.

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Exemptions

Exemption categories. The statute exempts nine categories of individuals from the requirement to carry MEC or make a payment. These statutory exemptions include the following:

- Religious conscience—members of a religious sect that is recognized as conscientiously opposed to accepting any insurance benefits. The Social Security Administration recognizes these sects;
- Members of a health care sharing ministry;
- Indian tribes—members of a federally recognized Indian tribe;
- No filing requirement—individuals whose household income is below the threshold for filing a tax return;
- Short coverage gap—individuals who go without coverage for three consecutive months or less during the year;
- Hardship—a health insurance marketplace, also known as an affordable insurance exchange, certifies that the individual suffered a hardship and cannot obtain coverage or would have to pay an excessive amount for coverage;
- Unaffordable coverage—the individual cannot afford coverage because the minimum amount owed for premiums is more than 8 percent of the individual's household income;

- Incarceration—the individual is in prison after the disposition of charges; and
- Not lawfully present—the individual is not a U.S. citizen or a resident alien.

An individual is exempt for a month if the individual is exempt for at least one day in the month, such as an incarcerated individual. An individual whose household income is below the return filing threshold is exempt for the entire year.

Claiming an exemption. The health insurance marketplaces will provide exemption certificates for many of the exemption categories, such as religious conscience or hardship. Some individuals will be able to claim an exemption on their federal income tax return (such as the 2014 return filed in 2015), for unaffordable coverage, short coverage gaps, and individuals outside the United States. Some categories of individuals may either go to a marketplace or claim the exemption on their return: members of Indian tribes or health care sharing ministries, and incarcerated individuals.

Calculating the Payment

The required payment is determined on a monthly basis. Under the proposed regulations, it equals the lesser of:

- The monthly penalty amounts for each individual in the family (up to three individuals); or
- The monthly national average bronze plan premiums for the family.

The monthly penalty amounts are the greater of:

- The flat dollar amount; or
- The excess income amount.

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The flat dollar amounts are $95 in 2014, $325 in 2015, or $695 in 2016. (After 2016 the amount is to be indexed for inflation.) For individuals under age 18, these amounts are reduced by half. The excess income amounts are the excess of the taxpayer's household income over the taxpayer's filing threshold, multiplied by a percentage:

- 1.0 percent for 2014;
- 2.0 percent for 2015; and
- 2.5 percent for years after 2015.

The monthly national average bronze plan premium is based on the annual national average premium for qualified health plans with a bronze level of coverage, offered through the exchanges.

Reporting of Health Insurance Coverage

Reporting requirements on insurers and employers were scheduled to take effect in 2014 for coverage in 2014, but the IRS has delayed these requirements until 2015. Under Code Sec. 6055, health insurers (which includes employers that self-insure) that provide MEC to any individual during the year must report certain information to the individual and to the IRS. The information includes:

- The name, address and Social Security number of the primary insured, as well as others covered by the plan;
- The dates of coverage;
- Whether the coverage is offered through an exchange; and
- The amount of any premium tax credit or cost-sharing reduction.

For an employer-sponsored plan, the insurer must also report the name, address and employer identification number of the employer, and the portion of the premium paid by the employer.

Reporting the Liability

A taxpayer is supposed to report his or her liability for the payment on the taxpayer's federal income tax return for the year. The payment is payable upon notice and demand by the IRS. However, the IRS cannot seek any criminal penalties and cannot place a lien or levy on the taxpayer's property for nonpayment. Accordingly, the IRS expects to collect the payment primarily through offsets to refunds.

STUDY QUESTION

1. Which of the following is included in MEC for individuals?

a. Medicare supplemental health insurance
b. Coverage for on-site medical clinics
c. COBRA continuation coverage
d. Coverage for a disease or specified illness

HEALTH INSURANCE EXCHANGES

Health insurance exchanges, also known as American Health Benefit Exchanges, play an essential role in PPACA's goal of expanding health insurance coverage. Under the health reform laws' plan, exchanges should be established in each state and be up and running by October 1, 2013, so that they can begin offering insurance for 2014 and beyond. Their role is to act as a marketplace for individuals and families who may lack insurance coverage or who are seeking less expensive coverage. Working with private

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health insurers, exchanges ideally will provide access to comprehensive health insurance at lower prices.

COMMENT

The exchanges play an important role in providing insurance. The Congressional Budget Office estimated that 7 million people will enroll in insurance through the individual marketplace in 2014.

COMMENT

PPACA also requires the establishment of a *Small Business Health Options Program Exchange* (SHOP Exchange) for small businesses that are looking for help launching plans because they find health insurance too expensive to offer to their employees.

Federal Government

HHS is primarily responsible for developing the rules for the exchanges and for the health plans they offer. Many states have chosen not to provide an exchange. For those states, the federal government will establish the exchange by the same October 1, 2013, deadline and will administer the exchange. The federal government and the state may enter into a partnership to administer the exchange.

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COMMENT

During 2013, only 16 states and the District of Columbia reportedly applied to run their own exchanges. The federal government was responsible for exchanges in the other 34 states, although state governments were expected to assist in 15 of the states.

Key Provisions

Although exchanges are not a creature of the tax code, they are necessary for the operation of the key tax provisions of PPACA described in this chapter: the individual mandate (or individual shared responsibility payment), the health insurance premium assistance tax credit, and the employer mandate (or employer shared responsibility payment).

COMMENT

These key PPACA provisions were all supposed to take effect in 2014. Although the employer mandate has been postponed, the individual mandate and the premium assistance tax credit will still take effect in 2014. The IRS has promised that the employer mandate will take effect in 2015.

Individuals and families do not owe a penalty under the individual mandate if they have minimum essential (health insurance) coverage; exchanges will provide this insurance. Individuals and families buying insurance through an exchange may qualify for the premium assistance tax credit, depending on their income level; exchanges will determine who is eligible for the credit. Employers will owe a penalty under the employer mandate if they fail to provide affordable, minimum value comprehensive health coverage, *and* if one or more employees purchase insurance through an exchange and qualify for the credit.

Employers are supposed to notify their employees about the following:

- That health insurance coverage is available through an exchange;
- The services provided by the exchange;
- Contact information for the exchange;
- That the employee may be eligible for the premium assistance tax credit; and
- That the employee may lose his or her employer contribution for employer-provided benefits.

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The Department of Labor has provided model language for the notices. DOL requires employers to start providing notices by October 1, 2013, when the exchanges were supposed to begin operating.

Information Sharing

Individuals are supposed to provide information to an exchange so that the exchange can enroll them in health insurance and determine their eligibility for the tax credit or for cost-sharing reductions (the latter administered by HHS). HHS determined that much of this information could be obtained from the IRS, rather than requiring individuals to fill out burdensome applications. In response, the IRS issued proposed regulations (NPRM REG-119632-11) in 2012 on the disclosure of return information to HHS to verify eligibility for the premium tax credit (including advance payments), state Medicaid programs, or other insurance offerings such as CHIP. HHS will then provide the information to the exchange or state agency processing an application for health insurance coverage. The IRS rules would limit disclosure to the year, the taxpayer's identity, filing status, dependents (family size), and adjusted gross income (or modified AGI if available).

COMMENT

The IRS has also issued proposed regulations (NPRM REG-140789-12) on the information that exchanges must report to the IRS on the premium assistance tax credits provide to individuals and families.

STUDY QUESTION

2. All of the following are key health insurance exchange provisions of the PPACA related to federal tax revenue ***except:***

a. The health insurance premium assistance tax credit
b. Employer mandate
c. Premium discounts for participants in wellness programs
d. Individual mandate

HEALTH INSURANCE PREMIUM ASSISTANCE TAX CREDIT

PPACA provides for the establishment of American Health Benefit Exchanges, as just described, in 2014. Individuals who do not have employer coverage or government coverage, for example, can shop at an exchange to purchase health insurance for themselves and their families. Health insurance offered through an exchange must offer "essential health benefits."

Beginning in 2014, an individual or family who purchases insurance through an exchange and whose income is below certain levels may apply and qualify for the premium assistance tax credit under Code Sec. 36B. The credit is refundable to the taxpayer. Alternatively, the credit may be paid in advance directly to the insurer; the taxpayer then must pay the difference between the premium and the credit. Individuals without group health insurance who want to satisfy the individual mandate will look to the exchanges for insurance and to the credit to help them pay for the insurance.

COMMENT

The Congressional Budget Office has estimated that the credit will provide an average annual subsidy of about $5,500 per year per subsidized individual or family who enrolls in insurance offered by an exchange.

COMMENT

Under the IRS regulations, an exchange includes a state exchange, a federally facilitated exchange, and a partnership exchange run by both a state and the federal government. Thus, individuals purchasing insurance through a federal exchange are potentially eligible for the credit. As discussed in the section on litigation, so opponents of PPACA are challenging the application of the credit (and the employer mandate) to federal exchanges, claiming that Congress only authorized the credit and the mandate for insurance purchased through a state exchange. Although the precise number may change, it appears that 34 state governments have opted not to provide an exchange, thus requiring the federal government to establish the exchange in those particular states.

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Eligibility

The credit is available on a sliding scale for individuals and families with household incomes between 100 percent and 400 percent of the federal poverty level (FPL) for the family size. The family includes the taxpayer, spouse, and dependents. Individuals who are not subject to the individual mandate can also be counted as part of the family. However, taxpayers cannot count a child who cannot be claimed as a dependent, echoing concerns about the treatment of dependents of divorced individuals. Individuals who are not lawfully in the U.S. cannot be counted. The credit amount is based on the percentage of income that the individual or family's share of premiums represents, rising from 2 percent of income for taxpayers at 100 percent of FPL, to 9.5 percent of income for those at 400 percent of FPL.

Household income is the taxpayer's modified adjusted gross income (MAGI) (including tax-exempt interest and untaxed Social Security benefits) plus the MAGI of any other household member who must file a return. Married taxpayers must file a joint return. Dependents are not eligible for the credit themselves but will enter into the calculation of the family's credit. An individual applying for the credit must provide information on income, family size, and changes in marital or family status. Initial eligibility for the credit is based on income for the year ending two years prior to the enrollment period.

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Interlocking Provisions

An individual is not eligible for the credit if he or she is eligible for MEC, other than coverage available in the individual market. MEC is an important concept affecting several of the PPACA requirements. The individual mandate and the premium assistance tax credit are both tied to the concept of MEC.

The proposed regulations under Code Sec. 5000A (pertaining to the individual mandate) define MEC. An individual who has health insurance qualifying as MEC will not owe the penalty under the individual mandate; thus, many commentators have asked the IRS to treat particular insurance coverage as MEC.

An individual who does not have MEC may be entitled to claim the premium assistance tax credit. Again, the issue is whether particular coverage held by an individual or offered to the individual is MEC. In this context, an individual may not want available coverage to be treated as MEC, so that the individual retains eligibility for the credit.

EXAMPLE

Disability coverage is not MEC. An individual who obtains disability coverage but who lacks comprehensive health insurance coverage does not have MEC and will owe the payment under the individual mandate (unless an exemption applies). At the same time, because the individual's disability coverage does not qualify as MEC, the individual lacks MEC and may be eligible for the premium assistance tax credit (assuming the individual's employer does not offer affordable, minimum value MEC).

IRS guidance. In Notice 2013-41, the IRS discussed whether an individual who otherwise may be eligible for the credit is being offered MEC. HHS may designate health benefits not specified in the tax code as MEC. In final regulations, HHS designated state high-risk pools and self-funded student health coverage as MEC, but only for a one-year transition period for plan years beginning before January 1, 2015. Starting January 1, 2015, sponsors of these plans must apply to HHS if they want them designated as MEC.

The IRS also clarified that individuals eligible for the following programs will not be treated as entitled to MEC unless they are in fact enrolled in one of them: Medicare Part A, TRICARE programs, state high-risk pools, and self-funded student health plans.

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Employer Coverage

There are two additional requirements for employer-provided coverage that affect whether an individual may qualify for the credit. The employer coverage must provide MEC. In addition, the employer coverage must provide "minimum value" and must be affordable. *Minimum value* means that the plan's share of the cost of providing benefits is at least 60 percent of the total costs. Coverage is not affordable if the employee's share of the premium for self-only coverage would exceed 9.5 percent of the employee's household income. If the employer coverage does not satisfy all three requirements, the employee can choose not to enroll in the employer's plan, select coverage through an exchange, and attempt to qualify for the credit.

COMMENT

In 2013 final regulations, the IRS affirmed that in applying the affordability test for MEC for family members the credit depends on whether the employee's share of the cost of *self-only* coverage exceeds 9.5 percent of household income, a standard that is easier to satisfy. Thus, the test makes it more difficult for an employee to qualify for the credit. This determination was controversial; many commentators thought that the affordability test should be based on the cost of *family* coverage. The IRS explained that PPACA requires that the test for related individuals be based on the cost of self-only coverage.

In Notice 2012-31 and in proposed reliance regulations (NPRM REG-125398-12) issued in 2013, the IRS clarified the minimum value requirement. The IRS provided several methods for determining minimum value, including:

- A minimum value calculator;
- A safe harbor;
- Actuarial certification; and
- Plan level for small group market plans.

The IRS proposed additional safe harbors that do not require use of the calculator. The safe harbors would specify parameters like the deductible level (for medical services and drugs), a cost-sharing percentage, and an out-of-pocket maximum.

Reporting and Excess Payments

An exchange must report information—both to the IRS and to the individual—on coverage provided to an individual, including identifying information for the insured, the level of coverage provided, the total premium before the credit, the amount of any advance premium, information to determine eligibility for the credit, and information to determine whether the individual received excess advance payments. The IRS issued proposed regulations (NPRM REG-140789-12) in 2013 on these requirements. Exchanges would have to report to the IRS on a monthly basis, by the 15th day following the month of coverage, and to the individual on an annual basis.

If the advance premium credit exceeds the credit amount that the taxpayer is entitled to, the taxpayer must show the excess on his or her income tax return. The excess that is owed to the IRS is subject to a limit, as the table shows.

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Table 1. Ceiling on Excess Payments with the Advance Premium Credit

Household Income	Limit
< 200% of FPL	$600
200%–299%	$1,500
300%–399%	$2,500

COMMENT

Taxpayers receiving an advance premium credit thus must file a return.

STUDY QUESTION

3. Eligibility requirements for the health insurance premium assistance tax credit are determined using all of the following ***except:***

a. Tax-exempt income and untaxed Social Security benefits
b. Dependents who claim the credit themselves
c. Household income level
d. Federal poverty level

SHARED RESPONSIBILITY FOR EMPLOYERS

PPACA's shared responsibility provision for employers (the employer mandate) requires employers to provide their employees with comprehensive health insurance that qualifies as MEC. The coverage must be affordable and must provide minimum value.

If the employer does not offer health insurance or offers health insurance that does not meet the requirements for MEC, affordability, and minimum value, the employer may be responsible for a shared responsibility payment (an *assessable payment*). For an employer to be liable, one or more of its employees must purchase health insurance through a health insurance exchange, and the employee must qualify for the health insurance premium assistance tax credit.

Like many other major provisions of the health care reform laws, the employer mandate was scheduled to take effect January 1, 2014. However, in mid-2013, the federal government announced that it was delaying the effective date of the employer mandate for one year, until January 1, 2015. For some parties, this unexpected delay ignited calls to delay the individual mandate and suggested that the employer mandate was not an essential part of PPACA.

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Nevertheless, the employer mandate remains a major provision designed to encourage employers to provide insurance or to help pay for the costs of health care reform. This provision is also known as the "pay or play" requirement. Employers are not relieved of the "shared responsibility" of the employer mandate, but the delayed implementation grants them more time to assess their employment practices and provision of health benefits so that the employers are better prepared to comply with the law when it first applies in 2015. The IRS has pledged to institute the employer mandate at the beginning of 2015 and not to postpone it further.

Large Employers

The employer mandate applies to an *applicable large employer* (ALE), which is an employer that employed an average of at least 50 full-time employees

and full-time equivalent (FTE) employees during the preceding calendar year. If an employer employs 50 or more full-time and FTE employees in 2014, the employer will be an ALE for 2015. The statute defines a *full-time employee* as an employee who on average was employed for at least 30 hours per week. Proposed reliance regulations (NPRM REG-138006-12) issued at the beginning of 2013 also treat 130 hours of service in a calendar month as full-time.

Solely for determining an ALE, the regulations count FTE employees as full-time employees. The proposed regulations determine FTEs by calculating the aggregate hours worked in a month by nonfull-time employees (counting up to 120 hours per employee) and dividing the total by 120.

A new employer is an ALE if it reasonably expects to employ an average of at least 50 full-time employees (including FTEs) during the current calendar year. Although the regs decline to exempt new employers from the employer mandate, the IRS indicated it would consider whether to provide safe harbors or presumptions to help new employers determine their status.

All entities treated as a single employer under Code Sec. 414 are treated as a single employer to determine whether the group is an ALE. If the group is an ALE, the penalty provisions apply to each member of the group separately.

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COMMENT

The IRS stated that the application of the employer mandate to temporary staffing agencies may be particularly challenging, especially the determination of what constitutes the employer for tax purposes. The IRS indicated that the final regulations on the employer mandate will provide an antiabuse rule to address the use of staffing agencies to evade Code Sec. 4980H.

Assessable Payments

An ALE owes an assessable payment if an employee obtains insurance through an exchange, is certified to receive a premium tax credit, and either:

- Under Code Sec. 4980H(a), the employer does not offer to all of its full-time employees and their dependents the opportunity to enroll in MEC (as defined in Code Sec. 5000A, the individual mandate) under an employer-sponsored plan; or
- Under Code Sec. 4980H(b), the employer offers its full-time employees and their dependents the opportunity to enroll in MEC, but, for an employee entitled to the premium tax credit, the coverage is either unaffordable (based on the employee's household income or fails to provide minimum value.

COMMENT

The requirements for determining the employer's liability apply to full-time employees, not to FTE employees. In Questions and Answers on the employer mandate, the IRS indicated that the proposed regulations provided a lookback measurement method for employers to determine who is a full-time employee, based on previous hours of service. This method is also described in Notices 2012-17 and 2012-58.

The proposed regulations clarify that employers may satisfy Code Sec. 4980H(a) by offering MEC to at least 95 percent of their full-time employees. This provides relief to an employer who inadvertently fails to offer coverage to one or more employees. The regulations affirm that the offer of coverage must be provided to both employees and their dependents. A *dependent* is defined as any child under 26 years of age; it does not include a spouse.

The penalty under Code Sec. 4980H(b) applies if the employee premium for coverage is unaffordable. Coverage that costs more than 9.5 percent of the employee's household income is unaffordable. To determine household income, the proposed regulations provided three safe harbors:

- The Form W-2 safe harbor, based on employee wages;
- The rate of pay safe harbor (based on hourly or monthly pay rates); and
- The federal poverty line safe harbor.

A plan provides minimum value if the plan covers at least 60 percent of the total cost of benefits that are expected to be incurred under the plan.

Calculation of the payment. For liability under Code Sec. 4980H(a), the employer would figure the payment using this equation:

$2,000 for the year × (Number of full-time employees for the year – 30).

If coverage is offered for some months but not for others during the calendar year, the employer's liability per month is:

$\frac{1}{12}^{th}$ of the annual amount (or $167 per month) × (Number of employees – 30).

For liability under Code Sec. 4980H(b), the employer would owe $3,000 times the number of full-time employees for the year who received a premium tax credit. If coverage is offered for some months but not others, the employer's liability per month is $\frac{1}{12}^{th}$ of the annual amount (or $250 per month) times the number of employees receiving the credit.

COMMENT

An employer cannot be liable under both Code Secs. 4980H(a) and (b). The penalty that is imposed cannot exceed the payment under Code Sec. 4980H(a).

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Procedure. The IRS will contact employers to inform them of their potential liability for the payment, and give them an opportunity to respond before any liability is assessed and before notice and demand for payment is made. There will not be self-reporting; employers will not make the payment on any tax return that they file. The IRS will act after employees' individual tax returns are due that claim premium tax credits, and after ALEs file information returns identifying their full-time employees and the coverage they were offered.

COMMENT

The postponement of the employer mandate until 2015 was accompanied by the postponement of reporting by employers and insurers under Code Sec. 6055 and by employers under Code Sec. 6056. Because this information would not be reported for 2014, the IRS concluded that it would not be practical to enforce the employer mandate for 2014.

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Transition Rules

The proposed regulations had provided several transition rules for 2014, when 2014—rather than 2015—would have been the first year for the employer mandate. One rule allows employers with plans on a fiscal year to wait to apply the standards until the first day of the plan year that begins in 2014. Another rule exempts employers from penalties in 2014 if they must add dependent coverage to their health plans. Other rules affected health plans offered through cafeteria plans and multiemployer plans.

COMMENT

The IRS is expected to update these transition rules in light of the postponement of the employer mandate until 2015.

Delay of the Employer Mandate

In Notice 2013-45, the IRS announced that the employer mandate would not apply for 2014. Because a reported 90 percent or more of employers provide MEC to their employees, the government has expressed the belief that the vast majority of employees will not be harmed by this postponement. Furthermore, the delay of the employer mandate does not affect the application of the individual mandate and the availability of health insurance premium tax credits for 2014. Individuals may still obtain insurance through an exchange and qualify for the credit.

COMMENT

Individuals will be asked to self-certify their eligibility. There is the potential for individuals to incorrectly claim the credit, driving up the cost of providing the credit. The government also will not receive any employer payments for 2014 to help offset the cost of offering the tax credits.

The reporting requirements for 2014 were also postponed. (In fact, the employer mandate itself was postponed primarily because businesses were having difficulty complying with the reporting requirements.) The IRS sought more time to work with stakeholders and the regulated community to develop reporting requirements that would not be duplicative and would be less burdensome. Code Sec. 6055 requires reporting of individuals receiving coverage. The reporting would be made by anyone providing health insurance, including health insurers and employers providing self-insured coverage. Code Sec. 6056 goes to the employer mandate and requires employers to report coverage provided to full-time employees. With these two provisions, there may be the potential for duplicative reporting by employers.

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COMMENT

Although reporting is not required for 2014, the government has encouraged employers and insurers to provide voluntary reporting for 2014, to give all parties experience with the reporting requirements.

Some of the rules prescribed for the employer mandate (30 hours per week for a full-time employee; 50 employees for an ALE) have been controversial, with unions and other interested parties claiming that employers may try to reduce their employees' work hours and may be discouraged from bringing in new employees if they are near the 50-employee threshold. However, these rules are in the statute and would have to be changed by Congress. The IRS developed the administrative standards for these rules after comments and hearing testimony from interested parties. There is no indication that the IRS intends to change these rules.

STUDY QUESTION

4. ALEs are offered relief from assessable payment obligations under the proposed regulations if they offer 95 percent of their full-time employees:

- **a.** Silver level plans
- **b.** Minimum essential coverage
- **c.** Dependent coverage for employees' children younger than age 23
- **d.** Group-plan coverage that is unaffordable

WELLNESS PROGRAMS

The IRS defines *wellness programs* as programs of health promotion and disease prevention. Employers and health insurers are turning to wellness programs as a mechanism to improve employee health. Wellness programs are voluntary for sponsors, insurers, and participants. An employer can choose whether to offer a program. Some employers start by offering a reward (such as a gift certificate) without linking the reward to the employer's health plan. This introduces the notion of health awareness to employees. Over time, employers tend to link their programs to their group health insurance coverage by offering premium reductions. A $350 annual reduction in premiums is not unusual.

If a self-insured employer offers a wellness program, any premium reduction offered by the employer will reduce the amount that the employee pays the employer. An employer and a third-party insurer may enter into a program to collect information on employee health and to provide reports for use by the employer. The insurer's program is offered in concert with the employer, not on a standalone basis, although an insurer in the individual market can also choose to offer a wellness program. If the employer reduces the employee's premium, the employer has to make up the different to the insurer. However, if the program increases employee health and leads to a reduction in the cost of claims, the insurer may reduce the premium that otherwise would have been charged to the employer.

Wellness programs can offer penalties as well as rewards. Either way, wellness programs are considered beneficial and are becoming increasingly popular. Studies indicate that providing incentives for employees to be healthier results in greater productivity and less absenteeism. Wellness programs may also reduce health costs and insurance costs, but studies are less clear about the link between wellness and reduced costs..

The IRS, together with the Departments of Labor (DOL) and HHS, jointly issued final regulations (TD 9620) on the design of wellness programs. The rules for wellness programs are effective for plan years beginning on or after January 1, 2014. The wellness program rules apply to all group health plans that offer wellness programs, including grandfathered and nongrandfathered plans. The rules give employers an opportunity to offer wellness programs to their employees.

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COMMENT

Wellness programs may also be offered in the individual market. For example, the *Public Health Service Act,* which includes wellness provisions administered by HHS, provides for a 10-state wellness demonstration program to be established in 2014.

HIPAA

The *Health Insurance Portability and Accountability Act of 1996* (HIPAA) prohibits group health plans and issuers from discriminating, based on a health factor, against individual participants and beneficiaries in eligibility, benefits, or premiums. There are eight health status-related factors:

- Health status;
- Medical condition;
- Claims experience;
- Receipt of health care;
- Medical history;
- Genetic information;
- Evidence of insurability; and
- Disability.

However, HIPAA excepts from the discrimination rules programs that allow premium discounts, rebates, or modifications to cost-sharing amounts, such as copayments and deductibles, in return for adhering to a wellness program. PPACA amended HIPAA mainly to incorporate nondiscrimination and wellness provisions previously adopted in 2006 regulations issued under HIPAA.

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Goals

The federal agencies recognize that each wellness program is unique. Thus, the regulations provide general guidance on the elements of wellness programs, not specific requirements. The rules set forth criteria that must be satisfied for a plan or issuer to qualify for an exception to the rules that prohibit discrimination based on a health factor. The agencies' intention is that the rules allow every individual participating in a wellness program to be able to receive the full amount of any reward or incentive, regardless of any health factor. There must be an equal opportunity to obtain the incentive or avoid the penalty. An employer must respond with reasonable alternatives, rather than just impose an initial standard.

COMMENT

In the final regulations, the IRS provided a mechanism for an employer to offer an incentive or charge a penalty for the employee's share of an insurance premium, depending on whether the individual complies with the wellness program requirements. The IRS also provided reasonable alternatives that wellness programs must offer to avoid violating the nondiscrimination rules. The agency designed the rules to provide flexibility and to encourage innovation and experimentation.

Program Categories

The regulations divide wellness programs into participatory wellness programs and health-contingent wellness programs. The regulations further divide health-contingent programs into activity-only programs and outcome-based programs. Plans and issuers with health-contingent wellness programs may vary benefits, premiums, or contributions based on an individual's meeting the standards of the program.

Participatory programs. *Participatory programs* either do not provide a reward or do not include any condition for obtaining a reward based on a standard related to a health factor. Participatory programs provide an incentive to participate; there are no conditions for the reward. These programs are not required to meet the five criteria that apply to health-contingent programs.

Participatory programs comply with the nondiscrimination requirements as long as participation is made available to all similarly situated individuals, regardless of health status. This compliance ensures that the general HIPAA prohibition against discrimination based on a health factor is not triggered. Distinctions are allowed based on employment classifications, consistent with the employer's usual practice, such as different treatment for part-time versus full-time employees. Unlike health-contingent programs, which have a general 30 percent cap, there is no limit on the financial incentives that may be provided for participatory wellness programs.

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EXAMPLE

Participatory programs include:

- Reimbursement for all or part of the cost of a fitness membership;
- Diagnostic testing programs that reward participation and do not base any reward on test outcomes;
- Programs that reimburse costs of participating or provide a reward for participating, as in smoking cessation programs, regardless of whether the employee quits smoking;
- Programs that reward employees who complete a health risk assessment, without requiring any further action; and
- Programs that encourage preventive care by waiving copayments or deductible requirements, such as for the costs of prenatal care or well-baby care

Health-contingent programs. A *health-contingent wellness program* requires an individual to satisfy a standard related to a health factor in order to obtain a reward. An important change in the final regulations increased the maximum permissible reward under a health-contingent program from the prior 20 percent limit to 30 percent of the cost of coverage. This limit

increases to 50 percent if the additional amount is for programs designed to prevent or reduce tobacco use.

The IRS imposed five requirements for health-contingent programs:

- Individuals must have an opportunity to qualify for the reward at least once a year;
- The total reward cannot exceed the specified limits;
- The program must be reasonably designed to promote health or prevent disease;
- Programs must be available to all similarly situated individuals. For both types of health-contingent programs, a reasonable alternative standard (or a waiver) must be made available to any individual for whom it is unreasonably difficult, due to a medical condition, to satisfy the standard; and
- The plan must disclose the availability of alternatives to qualify for the reward (or a waiver).

For *activity-only programs,* individuals must perform an activity to obtain a reward. They do not have to attain a specific health outcome.

EXAMPLE

Walking, diet, and exercise programs are classified as activity-only.

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Individuals who cannot participate because of a health factor (e.g., they are unable to walk because of surgery or pregnancy) must be provided a reasonable opportunity to qualify for the reward. Plans may seek verification from an individual's doctor that a health factor makes it unreasonable or inadvisable to attempt to satisfy the standard.

Under an *outcome-based program,* an individual must attain or maintain a specific health outcome, such as not smoking or attaining certain test results. These programs generally have two steps: a screening or test as part of an initial standard, and a larger program that targets individuals who do not meet the initial standard. For individuals who do not meet the specific health outcome, the program may offer compliance with an educational program or activity to achieve the same reward.

EXAMPLE

Ongoing testing for high cholesterol or blood pressure is an outcome-based program in that it rewards employees in a healthy range and requires employees outside the healthy range to take additional steps to obtain the reward. If an individual requests an alternative, the plan must accommodate recommendations from the individual's physician.

EXAMPLE

For a program with a goal to quit smoking, a reasonable alternative in Year 1 may be an educational seminar. For the succeeding year, the plan may require a different alternative, such as nicotine replacement therapy.

The specified cost-of-coverage percentages are based on the total costs of employee-only insurance coverage, including both employer and employee contributions. If dependents may participate in the wellness programs, the specified percentages are applied to the cost of family coverage.

A program is reasonably designed if it has a reasonable chance of improving health, is not overly burdensome, and is not a subterfuge for discrimination. Reliance on studies or evidence is not required, but is encouraged as a best practice. An outcome-based program must provide a reasonable alternative to individuals who do not meet the initial standard.

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Tax Consequences

The IRS has not addressed the tax consequences of wellness programs. Compliance with the requirements in the regulations does not affect the tax treatment of receiving a benefit. The benefits provided will be taxable or tax-free under general tax principles, such as the fringe benefit rules. A reduction in the insurance premium would not be taxed, but a cash reward that can be used for any purpose would be taxable income.

PPACA TAXES

PPACA enacted a number of new taxes to help pay for the cost of expanding health insurance coverage. The taxes are designed to raise billions of dollars per year. As part of PPACA's implementation, the IRS has been providing guidance on these fees and taxes. These taxes include:

- The tax on indoor tanning services, effective beginning in the second half of 2010;
- The branded prescription drug fee, effective as of 2011;
- The medical device excise tax, effective beginning in 2013; and
- The annual fee on health insurance providers, effective starting in 2014.

EXAMPLE

Generally, the taxes are treated as nondeductible excise taxes.

Tanning services. The 10 percent tax on indoor tanning services took effect July 1, 2010. The tax applies to the individual paying for the services and to amounts paid by insurance. The IRS issued temporary (T.D. 9486) and proposed regulations in June 2010; it issued final regulations (T.D. 9621) in June 2013.

The final regulations maintained an exemption from the tax for qualified physical fitness facilities that do not charge separately for indoor tanning services, do not offer tanning services to the general public, and do not offer different membership rates based on access to tanning services. The IRS declined to impose the tax on free services. If the tanning services are included in bundled services, the taxpayer must determine the amount attributable to tanning.

Branded prescription drugs. This fee applies to manufacturers and importers of branded prescription drugs sold in the U.S., if those organizations have receipts of more than $5 million a year. The fee is based on prior year sales. The aggregate fee imposed on all entities was $2.5 billion for 2011; $2.8 billion for 2012 and 2013; $3 billion for 2014 and 2015, with continued increases for future years. The fee is credited to the Medicare Part B trust fund.

The IRS will apportion the fee based on each entity's market share. In Notice 2012-74, the IRS set the parameters for calculating the 2012 fee. The IRS determines the fee by determining a ratio, equal to the entity's drug sales for the preceding calendar year over the aggregate drug sales for all entities. The IRS notified entities of its preliminary calculations by April 1, 2013, entities could submit error reports, but had to pay the fee by September 30, 2013.

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Medical devices. The tax took effect 2013 for sales after December 31, 2012. The tax is 2.3 percent of the price for sales of certain medical devices by manufacturers, producers, or importers. The IRS issued final regulations (T.D. 9604) on the tax at the end of 2012.

The tax applies to any device regulated by the Food and Drug Administration and meant for humans. The tax does not apply to products for animals, eyeglasses, contact lenses, hearing aids, and retail sales, that is, other medical devices generally purchased by the public at retail for individual use, including purchases from a store, by telephone, or over the Internet.

EXAMPLE

The regulation also exempts adhesive bandages, snake bite kits, denture adhesives, pregnancy test kits, blood glucose monitors and test strips, prosthetic legs, wheelchairs, portable oxygen concentrators, and adjustable home-use beds.

Health insurance providers. This tax will take effect in 2014. It is designed to raise $8 billion in 2014, increasing to $14.3 billion in 2018, and increasing after that by the rate of insurance premium growth. The fee is based on the ratio of the individual insurer's net premiums written on health insurance, divided by the total premiums of all insurers. The total tax to be raised is multiplied by this ratio, to determine each insurer's fee. The IRS issued proposed regulations (NPRM REG-118315-12) on the fee in March 2013.

The tax applies to health insurance premiums earned by health insurance issuers, health maintenance organizations, insurers providing Medicare Advantage or Medicaid, and nonfully insured multiple employer welfare arrangements. Health insurance includes dental, vision, and retiree health care. It does not include accident, disability, long-term care, or Medicare supplemental insurance. The tax does not apply to employers that self-insure their employees' health risks, to governmental entities (including Indian tribes), certain nonprofits, voluntary employee beneficiary associations (VEBAs) not established by employers, and universities charging health insurance fees to students.

Entities must report premiums by May 1 of each year. Like the branded prescription drug fees, the IRS will send preliminary bills, entities may submit an error report, and the IRS will then provide a final bill.

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STUDY QUESTION

5. The PPACA amended HIPAA primarily to:

- **a.** Revise nondiscrimination rules to comply with wellness provisions of PPACA
- **b.** Expand HIPAA's health status-related factors
- **c.** Cancel the premium discounts and rebates allowed under HIPAA
- **d.** Cancel allowed alternatives to wellness programs

SMALL EMPLOYER HEALTH CARE CREDIT

Small employers may take a credit for a percentage of health care premiums paid for their employees. The credit took effect in 2010 and continues through 2015. The credit is refundable and is available to employers with 25 or fewer FTE employees, when the average annual wages of its employees are no more than $50,000 per FTE.

For 2010 through 2013, the maximum credit has been 35 percent of health care costs for taxable employers. For 2014 and 2015, the maximum credit increases to 50 percent. For nonprofit employers, the maximum credit was 25 percent for 2010–2013, and 25 percent for 2014 and 2015. For tax years that begin after 2013, an employer must participate in an insurance exchange in order to claim the credit. The credit is no longer available after 2015.

MORE COURT CHALLENGES

In 2012, the Supreme Court issued an important decision that upheld PPACA (***National Federation of Independent Business, et al. v. Sebelius,*** 2012-2 USTC Par. 50,423). In a 5–4 decision, the court concluded that the individual mandate, which requires individuals either to carry health insurance or pay a shared responsibility payment, was a proper exercise of Congress's taxing power. The court declined to uphold PPACA based on Congress's powers over interstate commerce or powers under other Constitutional provisions. The court did overturn PPACA's expansion of the federal Medicaid program for low-income individuals, concluding that the federal government could not withhold existing funding to force states to expand their Medicaid coverage. States, however, could voluntarily extend Medicaid benefits.

Despite the Supreme Court decision, certain states, organizations, and individuals continue to challenge PPACA in court. These cases are contesting other portions of PPACA or raising new objections to the individual mandate. Some of the cases were filed before the Supreme Court ruled and were put on hold until the court issued its decision. Now, these cases are being resumed.

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COMMENT

Obviously, the federal government continues to implement PPACA administratively while the U.S. Department of Justice fights these cases in court.

EXAMPLE

Liberty University sued the federal government in 2010. Liberty and two individuals argued that the employer mandate (which was not the subject of the Supreme Court's decision) was unconstitutional because it was not supported by either the taxing power or the Commerce Clause. Liberty and the individuals also claimed that both the employer mandate and the individual mandate violate their religious freedom. In a July 2013 decision, the U.S. Court of Appeals for the Fourth Circuit affirmed a lower court's dismissal of the lawsuit (***Liberty University, Inc. v. Lew,*** CA-4, 2013-2 USTC Par. 50,432). The appeals court cited the Commerce Clause in upholding the employer mandate; it also determined that the mandates did not violate religious freedom.

Another legal challenge to PPACA focuses on the health insurance exchanges. The exchanges act as a marketplace within a state, at which uninsured people can shopfor health insurance from private insurers, perhaps at reduced prices. PPACA authorizes each state to set up its own exchange, but the state is not required to do so. If a state declines, PPACA authorizes the

federal government to set up a federal exchange for that state, presumably to offer the same features as a state exchange.

The premium assistance tax credit is available to qualifying individuals and families, but only if they purchase insurance through an exchange. The employer mandate is also tied to an exchange, because an employer does not owe payments under the employer mandate unless one or more of its employees purchases insurance through an exchange and qualifies for the credit.

The state of Oklahoma and others are claiming that Congress did not authorize the application of the premium tax credit and the employer mandate unless the exchange is set up by the state. Oklahoma claims that, under PPACA, the credit, and therefore the employer mandate, do not apply if the exchange is established by the federal government. Others argue that PPACA applies in the same manner whether the exchange is federally or state administered. The lawsuits are focusing on the IRS regulations issued under Code Sec. 36B (T.D. 9590), which treat federal and state management of exchanges the same.

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STUDY QUESTION

6. The health care credit for small employers is scheduled to:

- **a.** Decrease starting in 2014
- **b.** Apply at 50 percent in 2014 and 2015
- **c.** Continue at the same rate through 2016 for nonprofit employers
- **d.** End after 2016

CONCLUSION

PPACA is having a major impact on the provision and expansion of health insurance in the United States. The federal government, state governments, employers, individuals, and families are all affected by the law. In many cases, individuals and families will retain their existing insurance and will not have insurance plans changed by the law. However, several important provisions take effect in 2014; and one major provision—the employer mandate—is now scheduled to take effect in 2015. Individuals may need to consult with their employer, insurance company, or state government, to learn more about the law's requirements and its impact. Employers also need to review their responsibilities under the employer mandate, as well as plan compliance deadlines, options, and available credits.

MODULE 1: HEALTH CARE LAW: NEW REQUIREMENTS — CHAPTER 2

Net Investment Income Tax: Issues and Strategies

The net investment income tax, with its flat 3.8 percent rate, is the first tax imposed outside of the regular income tax in several decades. The impact of this surtax will be felt most often, but not always, by higher-income individuals, as well as certain trusts and estates. Those with moderate incomes will also feel the sting of the tax, however, if income suddenly spikes in any one year.

Although the net investment income tax has been part of the tax law since its enactment within the *Patient Protection and Affordable Care Act of 2010* (PPACA), it had a delayed effective date of tax years beginning after December 31, 2012. As a result, the tax is now effective for most taxpayers for the first time in 2013. The net investment income tax unfortunately has also had a delayed response from the IRS in issuing the guidance needed to comply fully with the law—and to fully plan effectively to avoid the tax when possible.

Stop-gap "proposed" regulations were not issued until less than a month before the tax took effect. Some practitioners have complained that the IRS has made a complex statute (Code Sec. 1411) even more complex through its dense set of regulations. Others have recommended that Congress rewrite Code Sec. 1411 itself before the tax can become manageable both for taxpayers and the IRS. Nevertheless, until better guidance is issued or a new version of Code Sec. 1411 is enacted, taxpayers must deal with the rules as they now exist in assessing their liability for this new tax that is now in effect.

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LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Understand the rationale behind Congress's enactment of the net investment income tax and the IRS' response to writing rules and regulations to implement this new tax;
- Determine the income levels at which the 3.8 percent net investment income tax is triggered;
- Identify the particular groups of taxpayers that are subject to, and those that are exempt from, the net investment income tax;
- Identify the three categories of net investment income that are subject to the net investment income tax;
- Explain the interrelationships between the passive activity loss rules of Code Sec. 469 and the net investment income tax of Code Sec. 1411;
- Understand when rental income is subject to net investment income tax and when it may be exempt; and
- Determine circumstances under which losses and other deductions are allowed to offset only net investment gain and when offset of all three categories of net investment income may be allowed.

INTRODUCTION

Code Sec. 1411 imposes a 3.8 percent net investment income tax (also known as the "unearned income Medicare contribution tax") on the lesser of an individual's:

- Net investment income for the tax year; or
- The excess, if any, of modified adjusted gross income (MAGI) for the tax year, over an applicable threshold amount.

The 3.8 percent net investment income tax is similarly imposed on trusts and estates, but under a different set of rules in connection with the net investment income base and threshold amounts.

IMPLEMENTATION OF THE NII TAX

Effective Date

Although approved in 2010 as part of the PPACA, the net investment income tax (NII tax) did not become effective until 2013. However, the NII tax is fully effective for all tax years beginning after December 31, 2012.

COMMENT

Net investment income is assessed on an annual basis. Therefore, a taxpayer whose income level ordinarily may not be subject to the NII tax may owe the tax during a year in which he or she experiences a spike in income, such as receiving a salary bonus, selling a large capital asset or business, or rolling over retirement funds to a Roth IRA. Planning that includes installment sales and other strategies to "even out" such income should be considered in such cases.

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Short Tax Years

The applicable threshold amount is generally not prorated in the case of a short tax year; for example, because of a taxpayer's death (Prop. Reg. § 1.1411-2(d)(2)). However, if the short year is the result of a change of annual accounting period, the regulations generally require reduction of the applicable threshold amount to an amount that bears the same ratio to the full threshold amount as the number of months in the short period bears to 12.

COMMENT

Individuals who are subject to the NII tax must report such income on their Form 1040, with accompanying new Form 8960, *Net Investment Income Tax—Individuals, Estates, and Trusts.* Estate and trusts attach Form 8960 to their Form 1041.

COMMENT

If items of net investment income (including properly allocable deductions) pass through a partnership or S corporation, the passthrough entity must separately state the items on Schedule K-1s issued to investors, a potentially burdensome requirement.

COMMENT

Interpretation of certain provisions of the NII tax as set forth under Code Sec. 1411 continues to be subject to debate. Specifically, certain positions taken under the Code Sec. 1411 proposed regulations have been subject to criticism and await final regulations for anticipated resolution. To the extent a taxpayer chooses to rely upon the proposed regulations during 2013, however, the IRS will not challenge their use even if final regulations alter a particular rule. Areas within the regulations of particular concern to practitioner groups include the inclusion of some rental income in NII when used in a trade or business, the application of the Code Sec. 469 passive loss rules to NII, and the computation of NII in the case of the sale of S corporation stock or a partnership interest by an owner who materially participates in the business.

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THRESHOLD AMOUNTS

The taxpayer's overall income, whether wages, net investment income, or other amounts that make up MAGI, must exceed a certain dollar level based on filing status before the NII tax may be imposed. The threshold amounts (which are not adjusted for inflation) are:

- $250,000 in the case of a taxpayer making a joint return or a surviving spouse;
- $125,000 in the case of a married taxpayer filing a separate return; and
- $200,000 in the case of any other individual (most notably, single unmarried individuals other than surviving spouses).

EXAMPLE

Assume that Joe Richards, a single filer, has income consisting only of wages of $180,000 and $15,000 of dividends and net capital gains. Because Joe's MAGI of $195,000 falls below the $200,000 threshold amount, none of his dividends and net capital gain is subject to the NII tax.

EXAMPLE

Assume that Herve and Alicia Rodriguez, a joint-filing married couple, earn combined salaries of $240,000 and have $30,000 in net capital gains. Because their total MAGI of $270,000 exceeds their $250,000 threshold by $20,000, $20,000 of their $30,000 net capital gain is subject to the 3.8 percent NII tax.

COMMENT

These threshold amounts are not indexed for inflation. Consequently, the number of affected taxpayers is expected to increase over time because of inflation. Congress could revise the thresholds in the future to reflect inflation or choose to index the thresholds for inflation. At the time of this writing, however, there appear to be no plans in Congress or the Obama Administration to index the thresholds for inflation.

Trusts and Estates

The threshold amounts for 2013 are $11,950 of adjusted gross (AGI) income in the case of trusts and estates, representing the threshold of the 39.6 percent income tax bracket for trusts and estates, and adjusted for inflation each year. Also, estates and trusts are only subject to the NII tax to the extent they have undistributed net investment income. Net investment income that is distributed and flows through to beneficiaries is considered the net investment income of those individuals, rather than NII of the trust or estate. Grantor trusts under the tax code also are considered to pass through NII to their grantors and are not themselves taxed.

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Adjusted Gross Income of Residents Abroad

For purposes of the NII tax, an individual's AGI for the tax year is increased by otherwise-excludable foreign earned income or foreign housing cost offset (as reduced by any deduction, exclusions, or credits properly allocable to or chargeable against such foreign earned income). This adjustment will only apply for U.S. citizens or residents who live abroad. Additional adjustments to AGI may be required because of ownership interests (for example, investments) in controlled foreign corporations or passive foreign investment companies.

COMMENT

Although the tax on NII is based on *netting* income and expenses, the threshold amounts do not take into account "below-the-line" itemized or standard deductions, personal exemptions, or credits, so that a taxpayer's taxable income may fall below a threshold dollar level yet still be subject to NII tax because MAGI exceeds the threshold. Deductible contributions to qualified pension plans and to IRAs do count, however, because they are deducted "above the line." These contributions also do double duty because distributions from such plans or IRAs do not count as net investment income, being specifically excluded under Code Sec. 1411.

STUDY QUESTION

1. When a taxpayer has a short tax year resulting from a change of annual accounting period, liability for net investment income is determined by:

a. Lumping items with the next accounting period's income
b. Figuring a reduced threshold based on the same ratio of months as a full year's NII threshold would have to 12
c. Reporting on Form 8960 without a Form 1040 or 1041 at the end of the short year
d. Lumping items with the prior accounting period's income and reporting on an amended return

TAXPAYERS SUBJECT TO THE NET INVESTMENT INCOME TAX

The NII tax applies only to individuals, trusts, and estates. It does not apply to corporations. Although passthrough entities such as partnerships and S corporations are not directly subject to the NII tax, income passed through to individual partners or shareholders may be subject to the NII tax depending upon the individual's active participation in the business of the partnership or S corporation. Exceptions to being subject to the NII tax are also carved out for certain individuals, trusts, and estates *(see further explanation, below)*.

COMMENT

The most significant factor that effectively exempts many individuals from the NII tax is the imposition of the tax only above certain threshold dollar amounts (as noted earlier). The NII tax is generally imposed only on "higher-income individuals."

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Individuals

The NII surtax applies to all individuals whose income exceeds the threshold, with the exception of nonresident aliens.

Joint returns: U.S. citizen or resident married to nonresident alien. For purposes of applying the NII tax to U.S. citizens or residents married to nonresident aliens, the spouses generally must be treated as married filing separately. Under normal rules, the nonresident alien's investment income will be exempt from NII tax, whereas the U.S. citizen or resident alien will be subject to the lower $125,000 threshold amount and must determine his or her separate net investment income and MAGI. However, if these married taxpayers have elected under Code Sec. 6013(g) to file jointly by treating the nonresident alien as a resident of the United States, the regulations allow the couple to elect to be treated as making the same election

for purposes of Code Sec. 1411 (under which the threshold amount is $250,000 and all income is combined).

Bona fide residents of U.S. territories. The application of the NII tax to a bona fide resident of a U.S. territory depends on whether the territory has a mirror code system of taxation. Residents of those territories that have a mirror system (Guam, the Northern Mariana Islands, and the United States Virgin Islands) generally are not subject to the NII tax. Bona fide residents of nonmirror code jurisdictions (American Samoa and Puerto Rico) are subject to NII tax if they have U.S. reportable income that gives rise to both NII and MAGI exceeding the threshold amount. However, a different result may apply to bona fide residents who are nonresident alien individuals.

Minors. The amounts of net investment income included on the parents' Form 1040 by reason of filing Form 8814, *Parents' Election to Report Child's Interest and Dividends,* are included in calculating the parents' net investment income. However, the calculation of NII does not include amounts excluded from their Form 1040 due to the threshold amounts on Form 8814.

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Bankruptcy estates. A bankruptcy debtor under Chapter 7 or Chapter 11 of the Bankruptcy Code who is an individual may be subject to the NII tax. In that case, the bankruptcy estate is subject to the same lower $125,000 threshold amount as a married taxpayer filing a separate return.

Trusts and Estates

Trusts and estates are subject to the NII tax on the *lesser* of:

- Undistributed net investment income, *or*
- The excess of AGI over the dollar amount at which the highest tax bracket begins (which, for 2013, is $11,950).

Tax-exempt trusts. The NII tax does not apply to any trust, fund or special account exempt from tax under Code Sec. 501 (exempt plans or organizations) or Sec. 664(c)(1) (charitable remainder trusts). This exemption includes any unrelated business taxable income comprised of NII.

Electing small business trusts. Special NII computational rules apply to electing small business trusts (ESBTs). Code Sec. 641(c)(1) provides that:

- The portion of any ESBT consisting of stock in one or more S corps must be treated as a separate trust; and
- The amount of tax imposed on such separate trust is determined under certain Code Sec. 641(c)(2) modifications.

The proposed reliance regs preserve this treatment of the ESBT as two separate trusts for computational purposes. However, the regulations

consolidate the ESBT into a single trust for determining the NII adjusted gross income threshold bracket amount "so as to not inequitably benefit ESBTs over other taxable trusts."

Foreign estates and trusts. Acknowledging that Code Sec. 1411 does not specifically address the treatment of foreign estates and foreign nongrantor trusts, the IRS has stated that it intends to tax NII of a foreign estate or foreign trust only to the extent the income is earned or accumulated for the benefit of, or distributed to, U.S. persons.

STUDY QUESTION

2. When a U.S. citizen is married to a nonresident alien:

- **a.** The citizen's income is subject to the $125,000 threshold for the NII tax liability
- **b.** The nonresident alien spouse's income is automatically combined with the citizen spouse's income subject to the $250,000 threshold for joint filing couples
- **c.** Each spouse's income is totaled individually using the $125,000 threshold for incurring the NII tax liability
- **d.** The income of each spouse is assessed NII tax only is both spouses have net investment income exceeding $250,000 for the year.

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NET INVESTMENT INCOME

The congressional intent behind the tax on net investment income under Code Sec. 1411 was basically to tax unearned, passive-type income, generated within a typical investment portfolio and from business income in which the taxpayer is a passive owner. However, the statutory language under Code Sec. 1411 used to realize this intention, to which many pages of regulations were added by the IRS to further explain Code Sec. 1411, has proven that a simple concept does not necessarily translate into simple rules. The complexity has been due largely to efforts to prevent "loopholes" on the one hand and a concern not to be "overly inclusive" on the other.

Net Investment Income for the Majority of Taxpayers

Although issues remain for precisely defining net investment income, the "typical" taxpayer should not lose sight of those common types of income that will ordinarily constitute net investment income. Common types of investment income subject to the NII tax include:

- Interest from bank accounts, certificates of deposits, and debt instruments held for investment;
- Dividends paid on stocks and mutual funds;

- Gains from the sale of stocks, bonds, and mutual funds (irrespective of whether such gain is long-term or short-term);
- Capital gains distributions from mutual funds;
- Income passed through to an inactive/passive partner or S corporation shareholder;
- The income portion of each annuity payment;
- Royalties held as investments;
- Rents from properties held but not actively managed; and
- Gain from the sale of investment real estate, particularly second homes.

COMMENT

Primary residences may also generate NII if gain exceeds the amount allowed under the Code Sec. 121 home sale exclusion of $500,000 for joint filers and $250,000 for most single taxpayers.

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What Net Investment Income Is Not

Net investment income does not include wages, unemployment compensation, operating income from a nonpassive business in which the taxpayer is a nonpassive participant, Social Security benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends, and distributions from qualified retirement plans. Although defining net investment income based upon what it is not incurs the same difficulties as providing a comprehensive definition, as do shorthand attempts at explaining what it is, it can help taxpayers understand the parameters of the NII tax more readily, with the "gray areas" left to a relatively small group of taxpayers to whom they may apply.

Use of other tax code provisions. The IRS has stated in its introduction (Preamble) to the proposed regulations under Code Sec. 1411 that, except as otherwise provided in the proposed reliance regs, the following Internal Revenue Code Chapter 1 regular income tax principles apply:

- Gain that is not recognized under Chapter 1 for a tax year is not recognized for that year for purposes of Section 1411, including:
  - Installment sales gain under Code Sec. 453,
  - Deferred gain on like-kind exchanges under Code Sec. 1031,
  - Deferred gain in involuntary conversion under Code Sec. 1033, and
  - Gain on the sale of a principal residence excluded under Code Sec. 121;
- Deferral or disallowance provisions of Chapter 1 that the proposed reliance regs interpret as applying to a determination of NII include:
  - Limitation on investment interest under Code Sec. 163(d),
  - Limitation of expense and interest relating to tax-exempt income under Code Sec. 265,

— At-risk limitations under Code Sec. 465(a)(2),
— Passive activity loss (PAL) limitations under Code Sec. 469(b),
— Partner loss limitations under Code Sec. 704(d),
— Capital loss carryover limitations under Code Sec. 1212(b), and
— S corp shareholder loss limitations under Code Sec. 1366(d)(2).

Further, carryover deductions in connection with these deferral or disallowance provisions otherwise allowed in determining AGI are also allowed in determining NII.

Exceptions to general tax code principles. "To prevent circumvention of the purposes of the statute," the proposed reliance regs modify the Chapter 1 rules in certain cases. Examples include treating substitute interest and dividends as investment income even though not technically considered dividends or interest under Chapter 1; and treating distributions under Code Secs. 959(d), 1293(c), and 1291 as net investment income. Also carved out from general Chapter 1 treatment is the definition of AGI as it relates to investments in controlled foreign corporations and passive foreign investment companies.

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NII Under Code Sec. 1411's Statutory Scheme

The complexity in determining exactly what constitutes net investment income in all cases arises from the language of the core subsections to Code Sec. 1411(c) itself, as shown in Figure 1.

Figure 1. Text of Code Sec. 1411(c) Subsections for Determining NII

1411(c)(1) ... The term "net investment income" means the excess (if any) of—

(1)(A) The sum of—

- (i) Gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),
- (ii) Other gross income derived from a trade or business described in paragraph (2), and
- (iii) Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2),

over—

(B) The deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

(2) A trade or business is "described in paragraph 2" if such trade or business is—

- A passive activity (within the meaning of Code Sec. 469) with respect to the taxpayer, or
- A trade or business of trading in financial instruments or commodities (as defined in Code Sec.475(e)(2)).

COMMENT

Code Sec 1411(c)(1)(i), (ii), and (iii) are often referred to by practitioners as Categories (i), (ii), and (iii).

COMMENT

Present confusion over the computation of net investment income has generally revolved around five issues:

- Determining when the level of activity constitutes a trade or business (particularly relevant to Category (i));
- Determining when the taxpayer's activity within a trade or business goes beyond the status of being a passive investor (particularly relevant to Categories (ii) and (iii));
- Determining in particular how real estate activities fit into the categories or their exceptions;
- Determining the gain subject to Category (iii) in case of the sale of an interest in a partnership or S corporation; and
- Determining what deductions may offset investment income or gain.

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Working capital. In addition to Category (i), (ii), and (iii) net income or gain, Congress added income from working capital to NII, irrespective of whether a business is active or passive.

Under Code Sec. 1411(c)(3) and proposed regulations, all gross income and gains derived from the investment of working capital is included in computing NII, regardless of whether such gross income is derived in a trade or business or such net gains are derived from property held in a trade or business. The IRS has stated that working capital for these purposes refers to "the capital set aside for use in and the future needs of a trade or business."

Code Sec. 1411(c)(3) sets forth the NII tax rules for investment income derived from working capital by providing that a rule "similar to" the rule in Code Sec. 469(e)(1)(B) applies for purposes of Code Sec. 1411.

Although Code Sec 469 is a deferral rule, Code Sec. 1411 is not. Identical rules may have the effect of causing businesses to maintain less working capital and may therefore create greater credit risk among small businesses, practitioners have complained. Specific guidelines for safe harbor rules within final regulations or elsewhere may be needed to avoid this additional risk.

EXAMPLE

Adam Birmingham is the sole owner/operator of a restaurant that does business as an S corp. He maintains an interest-bearing checking account with an average daily balance of $2,500 to hold cash receipts and pay ordinary and necessary business expenses. The S corp also has set aside an additional $20,000 for the potential future needs of the business. Both the checking account and $20,000 are considered working capital, with interest earned on them subject to NII surtax imposed on Adam, who is allocated the interest through the S corporation.

Trade or Business

An activity constitutes a trade or business for purposes of determining whether income or gain fits or is excluded from Category (i), (ii), or (iii) generally if it is considered a trade or business under the familiar Code Sec. 162 business expense rules. If the primary purpose for the activity is profit or income and if the activity has continuity and regularity, it is generally considered a trade or business. Nevertheless, case law requires that the determination of whether a trade or business exists from which income is derived must be based upon an examination of the facts of each case. A taxpayer's management of his or her own investments is not considered a trade or business under Code Sec. 162, however, even if the taxpayer engages in investment management activities on a full-time basis.

"Ordinary course." The proposed reliance regs do not provide guidance on the meaning of *ordinary course*. The IRS instructed that taxpayers should rely on case law and other sections of the regulations that address this issue, such as ***Lilly,*** 343 U.S. 90 (Sup.Ct. 1953), and Reg. § 1.469-2T(c)(3)(ii) (providing rules for determining whether certain portfolio income is excluded from the definition of passive activity gross income).

Wages. Wages and other compensation are not subject to the NII surtax. The IRS explained in the Preamble to the proposed reliance regs that amounts paid by an employer to an employee as wages subject to income tax withholding are not NII, because they are derived in the ordinary course of a trade or business of being an employee. In this manner, they qualify for the trade or business exception.

COMMENT

The IRS clarified in the Preamble to the proposed reliance regulations that nonqualified deferred compensation paid to an employee under Code Sec. 409A, 457(f), 457A, or other provisions is not NII.

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Trading in commodities and financial instruments. Income from a trade or business is included in net investment income if the trade or business is trading in financial instruments or commodities. The determination of whether trading in financial instruments or commodities rises to the level of a Code Sec. 162 trade or business is a question of fact, determined under the existing rules applicable to federal income taxes. Thus, a trader is engaged in a Code Sec. 162 trade or business if the trading is frequent and substantial, or frequent, regular, and continuous. In contrast, an investor trading on behalf of his or her own portfolio is generally not engaged in a trade or business, regardless of the extent of the investment activity.

A *financial instrument* includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of these items. An evidence of an interest in any of these items includes, but is not limited to, short positions or partial units in any of these items.

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STUDY QUESTION

3. Which of the following is ***not*** an indicator for Code Sec. 1411 tax provisions that an activity is a trade or business?

a. Infrequent activity involving financial instruments or commodities
b. Case law and other regulations have documented that the activity is a trade or business
c. The activity is conducted to create profit or income
d. The activity is considered a trade or activity under Code Sec. 162 rules

Taxpayer Activity

Net investment income does not include income from a trade or business in which the taxpayer materially participates. Accordingly, income from a passive activity counts toward net investment income as Category (ii) income (or Category (iii) gain). (Taxpayer participation in a transaction or transactions that do not amount to a trade or business similarly counts toward net investment income as Category (i) income.)

Material participation. Under the PAL rules, a taxpayer's activity is nonpassive if he or she materially participates in it. Material participation in an activity requires that a taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. The determination of a taxpayer's material participation in an activity is made for each tax year.

Portfolio Income

The PAL provisions under Code Sec. 469 provide several rules that restrict the ability of taxpayers to artificially generate passive income from certain types of passive activities. One set of these rules—on "portfolio interest"—applies to interest, dividends, annuities, or royalties. The PAL rules governing portfolio income generally apply to the NII tax as well. Portfolio income therefore is included in net investment income as Category (i) income because it is not derived in the ordinary course of a trade or business. Likewise, gross income from self-charged interest is also included in net investment income as Category (i) income from interest.

Real Estate Exceptions and Exclusions

Under Code Sec. 469, a passive activity can be a trade or business activity in which the taxpayer does not materially participate, or it can be a "rental activity" regardless of whether the taxpayer materially participates. A number of exceptions to the "per se" rental rules apply to activities that generate rent that are not considered rental activities under the passive activity rules. For example, rentals of equipment that last seven days or less are not treated as rental activities subject to this rule.

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COMMENT

The rules for the NII tax parallel this subset of PAL rules but do not adopt them entirely. This has caused a degree of confusion for which further guidance from the IRS has been requested.

Income from rental property. Whether rents are subject to the NII tax generally depends on several factors, including whether:

- The rents are derived in the ordinary course of a trade or business;
- The rents are derived from an activity the regulations under Code Sec. 469 except from rental activity; and/or
- The taxpayer satisfies the exception in IRC Sec. 469(c)(7) for "qualifying real estate professionals."

COMMENT

The rules for rents may be condensed into two axioms:

- If the rents *are not* derived in the ordinary course of a trade or business, the rents constitute net investment income (under Category (i)).
- If the rents *are* derived in the ordinary course of a trade or business, the rents constitute income from a passive activity included in net investment income unless Code Sec. 469 or its regulations except, exclude, or recharacterize the rents from passive income.

Real estate professional exception. Code Sec. 469 provides an exception for taxpayers in real property businesses (i.e., the real estate professional exception), under which the per-se passive activity classification of rental real estate does not apply. A taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the Code Sec. 469 PAL rules if the taxpayer performs more than:

- Half of the personal services he or she performs in trades or businesses in the tax year in real property trades or businesses, including real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses, in which the taxpayer materially participates; and
- 750 hours of services during the tax year in real property trades or businesses in which he or she materially participates.

If a real estate professional engages in a rental real estate activity that qualifies as a Code Sec. 162 trade or business and the real estate professional meets the material participation standard under Code Sec. 469 with respect to such activity, then the rental income from such activity is excluded from NII under the ordinary course of a trade or business exception.

However, if the rental real estate activity does not rise to the level of a trade or business under Code Sec.162 irrespective of material participation (involvement that is regular, continuous, and substantial), the rental income from that activity would apparently not qualify for the Category (i) exception—even if not treated as passive income under Code Sec. 469's material participation test. This issue is expected to be addressed more directly in the final regulations.

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Self-rented property recharacterization. The "self-rented property rule" under Reg. § 1.469-2(f)(6) recharacterizes from passive to nonpassive a taxpayer's rents from renting property to a trade or business activity in which the taxpayer materially participates. Under Reg. § 1.469-2(f)(6), the taxpayer's net rental income from the rental of property for use in a trade or business in which the taxpayer materially participates is treated as not arising from a passive activity.

Assuming that the property is rented in the ordinary course of a trade or business, the recharacterized income should be treated as nonpassive under both Code Sec. 469 and Code Sec. 1411, according to the view of most experts. Again, final regulations may address this issue more directly.

Developer recharacterization. The "developer rule" under Reg. § 1.469-2(f)(7) recharacterizes from passive to nonpassive a taxpayer's gain from disposing of rented property if the taxpayer had materially or significantly participated in the trade or business activity of developing the property. If

the taxpayer sold the property within 12 months after rental commenced, the gain is generally nonpassive. Gain that the developer rule recharacterizes as nonpassive under IRC Sec. 469 should not be treated as NII based on similar policies of fairness and the need for a bright line measure, according to most commentators.

Passive activity grouping rules. The PAL provisions provide rules for grouping passive activities together. Under the NII regulations, the PAL grouping rules also apply to the scope of a taxpayer's trade or business in determining whether it is a passive activity for the NII tax.

COMMENT

Historically, many taxpayers grouped activities as much as possible in order to maximize passive activity income and absorb PALs. However, because the NII tax applies to passive income, taxpayers may want to rethink their groupings.

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Under the proposed regulations, a taxpayer may do a one-time regrouping in the first tax year in which he or she is liable for the NII tax (without regard to the regrouping). The regrouping must comply with the existing PAL requirements, including disclosure requirements.

Interests in Partnerships and S Corps

As stated earlier, net investment income comprises three categories. Category (iii) income is net gain from the disposition of property, "other than property held in a trade or business not described in paragraph (2)" (that is, a trade or business that is not a passive activity with respect to the taxpayer and not a financial instruments/trading business). Thus, Category (iii) net gain includes income from the disposition of property that is used in a passive activity (as well as any asset not used in a trade or business), such as:

- The sale of publicly traded stock by an individual investor is Category (iii) net gain income because it is not associated with holding the stock within the context of a trade or business; and.
- The sale of stock in a closely held corporation also produces Category (iii) net gain for the same reason, unless the owner stock is also an active participant in its business through a partnership interest or S corporation.

Partnership interests and S corp stock are usually not considered property held in a trade or business (although they represent ownership in a trade or business). As a result, gain (or loss) from the disposition of a partnership interest or S corp stock under the general rule would be Category (iii) income and would be subject to the NII tax. *However,* Code Sec. 1411(c)(4)(A) provides an exception, which the proposed regulations (NPRM

REG-130507-11, December 5, 2012) refer to as an "adjustment." This exception is particularly valuable to the owner-employee of the typical small business that elects S corporation tax status or that operates as a partnership.

Exception. The exception applies to active interests in a partnership or S corporation that has a trade or business. The exception provides that the transferor of a partnership or S corporation interest only takes gain from the transfer into account (as net investment income) to the extent that the net gain would be taken into account (as NII) if all of the partnership or S corporation property were sold for fair market value in a deemed sale. (And to recapitulate, the net gain is NII only if the property was not held in a trade or business.)

Thus, the exception is a relief rule. This rule reduces the amount treated as NII. Because gain from property held in a trade or business is not net investment income, the exception reduces income from the transfer of a partnership/S corp interest, by the amount of the gain that would result from a deemed sale of the entity's property.

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EXAMPLE

Paul McKenna owns all of the stock in an S corp engaged in a trade or business. Paul is an active participant in the business. He sells all of his stock for a gain of $100,000. This amount would be treated as NII from a passive activity, if not for the exception.

If Paul's S corp had sold all of its property, it would have realized a gain of $100,000. The S corp's property is used in its trade or business; therefore, gain from the deemed sale is not NII because it is derived from "active" assets used in a trade or business. Thus, the adjustment to Paul's NII is $100,000. Although this amount is a gain, the proposed regulations refer to it as a negative adjustment, because it reduces the gain from the sale of the interest.

Under the exception, Paul's gain from the stock sale ($100,000) is adjusted (reduced) by the amount of gain from the deemed sale of the S corp's property (also $100,000). As a result, Paul's NII from the sale of the S corp stock is zero, and Paul does not owe any NII tax on his transfer of the S corp interest.

When adjustment applies. The proposed regulations apply the adjustment if:

- The partnership or S corp is engaged in one or more trades or businesses and at least one of its trades or businesses is not trading in financial instruments or commodities; and
- With respect to the partnership or S corp interest transferred, the transferor is engaged in at least one trade or business that is not a passive activity.

COMMENT

Thus, the adjustment is not available if the entity does not engage in a trade or business. The adjustment also is not available for the disposition of stock in an S corp if the transferor made an election under Code Sec. 338(h)(10) to treat the stock sale as a sale of the corporation's assets.

Installment sales. If a partnership or S corp interest is disposed of in an installment sale occurring on or after January 1, 2013 (the effective date of Code Sec. 1411), any adjustment of the net gain is determined in the year of disposition. The adjustment is taken into account in the same proportion of the total gain as the gain is taken into account under the installment sale rules (Code Sec. 453).

If the installment sale occurs before the effective date of Code Sec. 1411, taxpayers can elect to apply the exception. The taxpayer must file a computational statement with the taxpayer's original or amended return for the first taxable year in which the NII tax applies.

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Statement of adjustment. Under the proposed regulations, a transferor that applies the exception must attach a statement for the year of disposition of the interest in the entity. The statement must include:

- A description of the interest;
- The name and taxpayer identification number of the entity transferred;
- The fair market value of each of the entity's property;
- The entity's basis in each property;
- The transferor's allocable share of gain or loss for each of the entity's property;
- Information on whether the property was held in an active trade or business;
- The amount of net gain on the disposition of the interest; and
- The computation of the adjustment.

Deemed sale. To compute the adjustment on the sale of a partnership or S corp interest, the proposed regulations provide the following steps for the deemed sale and adjustment process:

1. A hypothetical disposition of all of the entity's properties (including goodwill) in a fully taxable transaction for cash equal to the fair market value of the properties immediately before the disposition of the interest;
2. The partnership or S corp determines the amount of gain or loss for each property. The gain or loss for each property must be computed separately;

3. The gain or loss from each property is allocated to the transferor. The allocation by a partnership must comply with Code Secs. 704(b) (distributive share) and 704(c) (allocation of gain to the transferor of property contributed to the partnership). The allocation by an S corp does not take into account any hypothetical imposition of tax on the deemed sale;
4. Gains or losses from all the properties are combined to determine whether there is a net gain or net loss from the deemed sale of the assets. The transferor then adjusts the gain or loss from the disposition of the interest by applying the net gain or loss from the property; and
5. If there is a gain from the property, the transferor reduces the gain from the transfer of the interest (a negative adjustment, according to the regulations). The gain cannot be reduced below zero to create a loss.

If there is a loss from the property, the transferor increases the gain from the transfer of the interest (a positive adjustment). The loss cannot be increased above zero to create a gain.

EXAMPLE

Alison McDougall owns 75 percent of the stock of an S corp engaged in a business. Bart Hanney owns the other 25 percent. Alison is an active participant; Bart is passive. The S corp holds three properties used in its trade or business, with an aggregate fair market value of $120,000, an aggregate basis of $100,000, and a gain of $20,000 on a deemed sale. Alison sells her interest to Charles for $90,000, with a basis of $75,000 and a gain of $15,000. Bart sells his interest for $30,000, with a basis of $25,000 and a gain of $5,000. The exception applies to Alison because she is an active participant in the S corp's business. The exception does not apply to Bart because he is a passive participant; his gain of $5,000 is subject to the NII tax.

As a 75 percent interest holder, Alison is allocated 75 percent of the $20,000 gain from the deemed sale of assets, or $15,000 in gain. This gain generates a negative adjustment to Alison's $15,000 gain from the sale of her S corp interest. As a result, her adjusted gain from the sale of the interest is zero, and none of the actual $15,000 gain on the sale of the interest is subject to the NII tax.

Repayment of reduced basis debt held by S corporation shareholder. Under Code Sec. 1367(b)(2), S corporation shareholders can loan money to the corporation and the basis of this debt can be used for the deduction of losses described in Code Sec. 1366. When this type of transaction occurs, the basis of the debt is reduced appropriately, according to Code Sec. 1367(b)(2)(A) *(reduced basis debt)*. When a written reduced basis debt is repaid prior to the basis of that debt being restored under Code Sec. 1367(b)(2)(B) through recognition of income, the repayment is treated as the sale or exchange under Code Sec. 1271(a)(1). Such capital gain or loss, if not

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considered attributable to the disposition of property held in a trade or business in which the taxpayer materially participates, may be subject to the NII computation of Category (iii) net gain.

If a shareholder of an S corporation with an activity in which the shareholder materially participates holds a reduced basis loan and part of that loan is repaid in a year when basis has not been fully restored, the active interests exception in Code Sec. 1411(c)(4) should apply. Such reduced basis debt should be considered in "an interest in a S corporation" for Code Sec. 1411(c)(4) purposes because this type of debt, with its unique characteristics, exists only when a taxpayer holds both a stock and debt "interest in a corporation."

STUDY QUESTION

4. In an installment sale of a partnership or S corp interest:

a. No adjustment is allowed because payments range across tax periods
b. Adjustment of the net gain is determined in the year of disposition
c. The adjustment is accelerated into the earliest months of installment payments
d. The entire adjustment is taken into account in the year of disposition

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Exception for self-employment income. Under Code Sec. 1411(c)(6), net investment income does not include amounts subject to *Self-Employment Contribution Act* (SECA) tax or any item taken into account in determining self-employment income. (For self-employment income, the tax code imposes a separate 0.9 percent additional Medicare tax under Code Sec. 1401(b).) The proposed regulations explain that "taken into account" means income included and deductions allowed in determining net earnings from self-employment. Amounts that are not taken into account may be included in net investment income if the amounts otherwise satisfy the definition of NII.

Traders. Net investment income includes "other" gross income from a trade or business of trading in financial instruments or commodities. Deductions allocable to the trade or business of trading in financial instruments or commodities are taken into account only to the extent they reduce the taxpayer's net earnings from self-employment. Any deductions that exceed net earnings from self-employment are allowed in determining net investment income. The IRS indicated that this treatment of the deductions will apply if the taxpayer is engaged in a trade or business of trading in financial instruments or commodities and does not have any net earnings from self-employment.