McGladrey files comments on new 3.8 percent investment income tax

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Beginning in 2013, section 1411 of the tax code imposes a new 3.8 percent tax on the investment income of millions of Americans. Although the text of the statute is quite brief, the new law presents very difficult technical and conceptual issues. Foremost among these is the practical need to integrate the operation of this new tax with the regular income tax.

In proposed regulations issued earlier this year, but generally not effective until 2014 even if adopted in their current form, the IRS has done a very good job of identifying a host of technical issues where the policies, structure and operational rules of the regular income tax appear to conflict with the apparent policies of section 1411. However, it appears the proposed regulations would resolve too many of those conflicts in a manner that would frustrate what we believe to be Congressional intent and unduly interfere with the economy.

McGladrey has filed comments on the proposed regulations suggesting several modifications before the regulations are issued in final form.

Summary of McGladrey's recommendations to the IRS

We identified, and explain more fully below, four issues the resolution of which we believe to be of primary importance. In our view:

1. The final regulations should remove the general prohibition on deducting section 165 losses in computing net investment income (NII). Such losses should be allowable, at least to the extent allowed for income tax purposes, against any source of gross investment income or gain.

2. The final regulations should allow taxpayers to defer or capitalize, solely for purposes of the net investment income tax (NIIT), income tax deductions that are not used against NII in the taxable year in which they are used for income tax purposes because there is insufficient NII in that year. We believe the statutory language referring to deductions "properly allocable" is flexible enough to encompass the concept of deferring or capitalizing an item, solely for NIIT purposes, to better match it with the income to which it economically relates.

3. "Self-rental" and similar problems should be addressed by clarifying that the income tax deductions of a NIIT-exempt business (i.e., a non-trading business in which the taxpayer materially participates) for payments of rent, interest or similar amounts, to the extent they are effectively paid by and received by the identical taxpayers, albeit through different entities, should be considered to be "deductions allowed by this subtitle which are properly allocable to" such items of gross income.

4. Finally, in light of the fact that there is no capital gains preference in the NIIT and thus the policy rationale for limiting capital losses to capital gains may not be applicable, we asked the IRS to consider whether the statutory language is flexible enough to allow the final regulations to provide that a capital loss that is "allowed as a deduction" by section 165(a), but limited by section 165(f) for income tax purposes, is nevertheless "allowed by this subtitle . . . [and] properly allocable to" net investment income for NIIT purposes.

Background: Overview of the section 1411 tax

The net investment income tax (NIIT) is imposed at a flat 3.8 percent rate on the taxpayer's net investment income (NII) in any given year, but only to the extent the taxpayer's total income in the year from all sources exceeds $250,000, $200,000 or $125,000, depending on whether the taxpayer is a married couple filing jointly, an unmarried taxpayer, or a married taxpayer filing separately. Technically, the test turns on the taxpayer's modified adjusted gross income (MAGI). These threshold amounts are not indexed for inflation, and the MAGI threshold is near zero for the undistributed income of a non-grantor trust or estate. Accordingly, it can be expected–absent legislative action–that many more taxpayers will eventually be subject to the new 3.8 percent tax on their first dollar of NII. For example, after 20 years of 6 percent inflation, a married couple with $75,000 of wage income in today's dollars will have a nominal MAGI in excess of the $250,000 threshold for imposition of the NIIT. That is why "getting it right" now is so important.

In addition, we note that the American Taxpayer Relief Act of 2012 includes various tax burdens that also apply only to the extent the taxpayer's adjusted gross income

(AGI) exceeds comparable levels. All of these new rules will undoubtedly add substantial tax complexity to the investment process. Analyzing a decision to recognize a capital gain, for example, is no longer a simple question of applying a capital gains tax rate determined by the nature of the asset and its holding period. Taxpayers and their advisors must now also consider the amount of other sources of MAGI or AGI in the taxable year. That is because the actual marginal tax rate on such a sale can now vary between 15 percent and roughly 25 percent for long-term capital gains and between 35 percent and roughly 45 percent for short-term gains. To avoid imposing undue hindrances on private investment and the economy, the regulations under section 1411 should endeavor to minimize any harsh or untoward effects that are not strictly required by the statutory language.

In our view, the most significant problems integrating the NIIT and the regular income tax would arise even if the MAGI threshold for the NIIT were zero. That is because the determination of what constitutes NII is not simple, except in the most basic fact patterns.

For example, in the case of a cash sale of a share of publicly traded stock purchased for cash, gross income or "gain" is the excess of the amount realized over adjusted basis, and net income generally equals gross income. In many other situations, however, not all of the costs, expenses or other amounts "invested" in an income-producing endeavor are capitalized into the basis of a specific asset for income tax purposes. Instead, such items are incurred and taken into account as deductions, often in taxable years before or after the year in which the related gross receipts or gross income are taken into account. For example, investment interest incurred in the taxable year to acquire a specific investment asset that has not yet generated any income may be allowed as a deduction against investment income realized in the same year from an entirely different asset.

The income tax deals with such problems reasonably well, generally by allowing such expenses as currently deductible expenses–subject to a few sensible rules intended to protect the revenues by isolating certain types of income in three major categories. In the main, those rules consist of (1) the limitation on deducting capital losses against non-capital income, (2) the limitation on deducting investment interest or expenses against non-investment income, and (3) the deferral of aggregate, net passive losses, except to the extent that any particular passive investment responsible for such a loss is sold or otherwise disposed of.

This approach does not integrate easily with a tax, like the NIIT, that is imposed only on certain types of income and only in certain years, with no explicit provision for carryovers, carrybacks, or the like. In addition, the three “buckets” that comprise NII do not conform to the three categories of regular income.

For income tax purposes, the three major categories of investment income are:

1. Capital gains and losses, including those from businesses,
2. Other investment income and expenses (including gains not taxed as long-term capital gains because they are effectively offset by such expenses), and
3. Passive activity income and losses (which generally exclude portfolio income and portfolio gains)

In contrast, under section 1411, the three major categories of gross investment income are:

1. Portfolio income (other than gains, and other than any income from a non-trading business in which the taxpayer materially participates, which might be referred to as an "exempt business"),
2. "Other gross income" derived from a trade or business (other than an exempt business), and
3. "Net gains" (other than from an exempt business)

As can be seen, under section 1411, a single item of gain may be described both in the second bucket and the third bucket. That is, the "net gain" bucket is *not* defined as net gain from property "other than property held in a trade or business." Rather, it is defined (emphasis supplied) as net gain from property "other than property held in a trade or business *not described in paragraph (2)* [referring to a non-trading business in which the taxpayer materially participates]." Had Congress so desired, the deletion of the phrase "not described in paragraph (2)," would have made it clear that net gain from a trading business or a business in which the taxpayer does not materially participate is described only in the second bucket and not in the third bucket. The presence of those words makes it clear that such amounts are described in both the second and third buckets. In addition, there is nothing in the statute or legislative history to suggest that this list was intended to be interpreted as a "waterfall" in which items described in both the second and third buckets would fall only into the second bucket. (The word "other" in the second bucket indicates that an item described in the first bucket may not be described in the second bucket, but no such language exists as to the second and third buckets.) Adding to the confusion, under the income tax, capital losses are matched with capital gains but generally without regard to whether they are derived in any business, and investment interest may be used to offset capital gains (or dividends potentially taxable as long-term capital gains) because that offset eliminates the capital gains benefit.

Finally, under the statutory language of section 1411, the three buckets of "gross" investment income are not separately reduced by their associated deductions. Instead, the three buckets are added together, and the resulting *sum* is then offset by deductions "properly allocable to such gross income or net gains." We believe that the statute would have been drafted differently if the drafters had intended any required “matching” of such deductions with income from particular buckets.

The IRS has done an excellent job of identifying the issues created by these and related differences between the structure of the income tax and the NIIT. We hope that the suggestions described below will be taken into account in crafting final regulations to address these structural problems.

Specific McGladrey recommendations for IRS consideration

1. Eliminate the proposed general regulatory ban on deducting section 165 losses

The income tax imposes severe constraints on deducting capital losses against non-capital income, generally prohibits carrybacks of such losses for individuals, and imposes a variety of limitations on deducting ordinary losses under section 165, including losses that become section 165 deductions through the operation of other provisions such as sections 475, 988 or 1231. There does not appear to be any reason to impose additional limitations on those deductions for NIIT purposes, as the proposed regulations would do. Indeed, in our view, the statute does not authorize such limitations.

For example, where a landlord owns four beachfront rental properties in New Jersey, one is partially destroyed by a devastating hurricane, and another is thereupon sold at a loss, there is no reason to disallow the landlord's losses against the rental income generated by his remaining properties (assuming they are treated as distinct activities) or against other portfolio income generated with the proceeds of a sale. It is burdensome enough, in some cases, that such losses may not be carried back to prior years for NIIT purposes. There is no need to impose added burdens that do not exist in the income tax rules.

Similarly, the regulations should not prevent an investor in a “trader” hedge fund–incurring a capital loss, say, from the sale of GM stock by the fund–from deducting or netting that loss against a gain, say, from the sale of Google stock by the identical fund, by another fund, or by the taxpayer in its individual trading activities (including any investor funds). That appears to be the result required by the proposed regulations. Specifically, if a trader hedge fund (or other passive or trading business) incurs a section 165 loss and a section 61 gain on separate transactions, the proposed regulations appear to preclude the deduction of the section 165 loss against the section 61 gain from the same fund, or from any other fund, or from section 61 gains realized by an individual outside of any trading or passive business.

The regulations also should not preclude the deduction of individual capital losses (i.e., losses incurred outside of any trading or passive business) against capital gains recognized through a trader hedge fund or other trading or passive business. That also appears to be the effect of excluding section 165 from the deductions “allowed by this subtitle which are properly allocable to such gross income or net gain.”

Again, we see no statutory or policy argument for the view that our hypothetical landlord’s section 165 losses (rendered ordinary by section 1231) are not “properly allocable” to his rental income or, for that matter, to other types of portfolio income if he were to replace one of his rental properties with a bond, annuity or royalty trust. Furthermore, we see no statutory or policy argument for the view that a capital loss from a taxpayer’s individual investment portfolio should not be allowable against capital gains derived from an investment in a trader hedge fund or other trading or passive business.

If there is a concern with deducting capital losses against non-capital income (about which we comment more specifically below), the existing income tax rules of section 165(f) are adequate to that task. There is no need for, or statutory support for, any additional limitations.

We do note that certain section 165 losses may be taken into account in the determination of “net gain” from the disposition of property in an individual investment portfolio. That could include both capital gains and ordinary gains, such as the gain from the sale of certain foreign currency instruments or the gains arising under section 475 for an electing trader. However, the fact that some of those section 165 losses are used up in the determination of “net gain” does not mean that any remaining section 165 losses from the portfolio are not *also* deductions “allowed by this subtitle” and properly allocable to other investment income–such as the rental income of our hypothetical New Jersey landlord (if the losses are ordinary losses that can be used against rental income) or the gains he may have from a trader hedge fund (if the losses are capital losses).

Certainly, the same section 165 loss should not be used twice. Yet, if it is not used even once in the determination of “net gain,” there is no reason it would not qualify as a deduction “allowed by this subtitle” and properly allocable to gross investment income from whatever bucket derived, subject only to the limitations on deducting capital losses against non-capital income (about which we have additional comments below).

2. Consider allowing income tax deductions to be deferred solely for NIIT purposes

The case of the landlord and his beachfront properties highlights another problem that may arise when losses are allowed and utilized for income tax purposes, but not usable for NIIT purposes because they exceed the amount of the taxpayer’s gross income from investments in the year the loss is incurred. If the landlord’s section 1231 loss is fully allowed for income tax purposes but far exceeds his net investment income in that year, his rents in future years are being overtaxed under the NIIT (assuming the properties are not aggregated or grouped for passive loss purposes). The landlord's future rental income should be reduced, for NIIT purposes, by the section 165 or section 1231 losses realized and recognized in earlier years (for income tax purposes but not for NIIT purposes) at the time the two rental properties were damaged or disposed of.

Although there is no explicit provision allowing for a carryover or carryback under the NIIT (in situations where there is no carryover or carryback for income tax purposes), the statute does provide for the subtraction, from gross NII, of deductions that are "properly allocable" to such amounts. We see no reason why the concept of "properly allocable" could not recognize that an income tax deduction allowed for income tax purposes, in a year in which there is no NII, is "properly allocable" for NIIT purposes to NII taken into account in a subsequent year. The general concept of an amount being "properly allocable" to an item of income or gain encompasses timing as well as other considerations. In effect, it would be like capitalizing an amount for NIIT purposes even though it is expensed for purposes of the income tax.

In short, we requested that the IRS consider final regulations allowing losses or deductions in such a case to be deferred or capitalized, solely for NIIT purposes, and recovered to the extent there is NII in later years. This is no more cumbersome or complex than similar computations done for alternative minimum tax purposes, at-risk purposes, passive loss purposes or the like. In addition, it seems well within the authority of the IRS under the statute to determine that a deduction taken into account for income tax purposes in one year may be "properly allocable" for NIIT purposes to investment income realized in a later year. It should be remembered that the deduction is being deferred for NIIT purposes because there is no NII, not accelerated.

3. Clarify the treatment of self-rental income and similar items

Section 1411 does not apply to rental income, interest income or similar income derived in the ordinary course of a non-trading business in which the taxpayer materially participates, within the meaning of section 469. In many cases, there are substantial, non-tax business reasons to conduct business through multiple entities – including entities whose activities might not rise to the level of a "trade or business" if they were viewed in isolation.

Ideally, the final regulations would clarify that rents, interest or similar items that are *incurred* by a taxpayer in the course of a non-trading business in which the taxpayer material participates are excluded from that taxpayer's gross investment income under section 1411 to the extent they are *received* by the same taxpayer, regardless of whether such amounts are received directly in the taxpayer's individual capacity or received through an entity that may or may not constitute a "trade or business" viewed in isolation.[1]

Whether or not such an approach is possible, we suggested that another very practical solution to the problem of "self-rental activities" (and similar issues arising with interest, royalties or other items) under section 1411 be adopted. We recommended that the final regulations resolve this problem by clarifying the rules allowing the subtraction from gross investment income of deductions that are "properly allocable" to such income. Simply put, the income tax deductions of an exempt business (i.e., a non-trading business in which the taxpayer materially participates) for payments of rent, interest or similar amounts that are effectively paid by and received by the identical taxpayers, albeit through different entities, should be considered to be "deductions allowed by this subtitle which are properly allocable to" such items of gross income.

Our suggestion can best be explained with an example.

> A, B, C and D each own 25 percent of ABCD, an LLC that owns property that is triple-net-leased for 20 years to AB, an operating business structured as an LLC that is owned in equal shares by A and B. Without regard to whether ABCD is a business in the first place, and without regard to whether it is properly grouped or aggregated with AB for any purposes, a portion of the rental deductions of AB that are passed through to A and B should be considered to be "properly allocable" to the rents that A and B receive from ABCD.
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> Specifically, if the rental deductions are $100 in total, with $50 apiece allocable to A and to B, and both A and B are also allocated $25 of rental

[1]That result could be reached in a variety of ways, including through clarification that a single trade or business, for purposes of the application of sections 162 and 469 to section 1411, may extend beyond the boundaries of a single entity. That possibility is implied by section 465(c)(3)(B), which allows the aggregation in certain cases of separate "activities" that constitute "a" trade or business, implying that a single business can be conducted through separate entities. Whether or not the requirements for such aggregation under section 465 are satisfied in any particular case, the underlying premise seems to be that a single trade or business may, in theory, be conducted through multiple entities or conducted by an individual as a proprietor and as an owner of a pass-through entity. The self-rental situation seems to be a perfect illustration of that phenomenon, whether the landlord is the individual partner leasing property to a partnership in which the landlord is a partner, or one partnership is passively leasing property to another partnership with substantially common ownership.

We recognize, of course, that some case law suggests that the determination of whether a partnership or other entity has commenced a trade or business, for purposes of its deductions, must be determined without regard to whether its partners or owners are already engaged in a similar business. That case law may not be applicable where one is considering amounts paid from one entity to another entity in connection with the simultaneous conduct by the two entities and their owners of a single trade or business, even if one entity, viewed in isolation, would not have sufficient activity to constitute a trade or business.

> income on account of those payments, A and B should each be permitted to treat $25 of their $50 of rental deductions as being "properly allocable" to the corresponding $25 of rental income for NIIT purposes. That is, those deductions are "properly allocable" in part to the rental income of A and B, even though they are incurred in a business whose income is exempt from NIIT.
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> In the event that AB was an S corporation, a similar rule could apply to treat a portion of the S corporation's deductions (taken into account in the computation of its net income for income tax purposes, but excluded from the NIIT computation because of the taxpayers' material participation) as also properly allocable (for NIIT purposes) to the computation of the NII of A and B, even though those deductions are incurred by a business whose income is exempt from NIIT.
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> A similar rule should apply if, for example, an S corporation borrowed money from one or more of its shareholders. To the extent the shareholders receive interest income from the S corporation with respect to the loans, the shareholders should be permitted to treat an equivalent amount of the interest expense passed through by the S corporation as a deduction for purposes of computing net investment income.

There is very little tax policy reason to interfere with taxpayers structuring their self-rental or self-charged interest arrangements in the manner they judge best for non-tax business considerations. We recognize the possibility that the IRS may feel bound to issue regulations providing that every entity receiving rents, interest or similar items must be a section 162 business in its own right in order for those items to be excluded from the first bucket of net investment income. There is no apparent reason that the IRS may not simultaneously conclude that such amounts may be offset, for NIIT purposes, by the income tax deductions claimed by the same taxpayers for the identical amounts paid to themselves, albeit through a distinct landlord entity and tenant entity or lender and borrower entities, in each case only the latter of which pair may qualify as a section 162 business in its own right.

As a matter of Congressional intent, it does not appear that a 3.8 percent tax should be imposed on "gross rental income" that is fully offset by an economically allocable expense in the identical amount, attributable to the identical payment, and made and received by the same taxpayer, albeit through different entities. In our view, a clearer case of an expense that is "properly allocable" to a particular item of investment income would be difficult to find. For a similar application of this approach to "matching" income and deductions, see Regs. section 1.469-7(a)(1)(i) and (ii), and (d).

In sum, this approach–relying on a sensible and economically reasonable interpretation of the term "properly allocable"–would appear to be well-suited to the issues arising under section 1411, even if the IRS cannot completely reconcile the complex and potentially conflicting rules and authorities related to aggregating or disaggregating activities, entities or businesses in sections 1411, 469, 465, 166 and 162 and other provisions.

4. Consider liberalizing the capital loss rules for NIIT purposes

As described above, there is no reason for imposing a stricter rule for section 165 deductions under the NIIT than the rule applicable for income tax purposes. In our view, there is actually a policy argument for a more liberal rule, and there may also be sufficient flexibility in the statutory language to accommodate such a rule. At a minimum, we would respectfully ask the IRS to consider the issue.

The original goal of the predecessor to section 165(f) was to prevent the harvesting and use of capital losses against ordinary income in certain years, while capital gains were recognized in other years and taxed at preferential rates. That concern does not appear to apply to a "flat" net investment income tax with no preference for capital gains. Thus, there is certainly a strong policy argument that a capital loss "allowed" under section 165, but limited for income tax purposes to capital gains, should be treated under section 1411 as a deduction that is "allowed by this subtitle and properly allocable" to any type of investment income, without regard to the income tax rule allowing such losses only against capital gains.

For example, assume an elderly investor who has incurred and paid income taxes on her investment portfolio throughout her investing life incurs substantial capital losses in 2008 and decides to shift her portfolio into safer assets that are unlikely to generate capital gains or capital losses, such as bonds, utility stocks, annuities or royalty trusts. Such a taxpayer would be subjected to the NIIT on future portfolio income that is not, in any economic sense, net investment income.

It can certainly be argued that a "solution" to such problems should await a larger solution to the same problems under the income tax. (For example, such a legislative solution might allow capital losses to be utilized without limitation as long as the taxpayer had no built-in gains in any capital assets.) On the other hand, if there is a possibility that this 3.8 percent tax may grow in size and importance due to the lack of indexation of the MAGI threshold, the tax law should arguably "get it right" here, even if the income tax approach to these problems must await Congressional action.

If the IRS agrees that there is no policy reason to preclude the deduction of capital losses against non-capital items of gross investment income for NIIT purposes, the statutory language may be sufficiently flexible to permit the IRS to conclude that a capital loss that is “allowed as a deduction” by section 165(a), but limited by section 165(f) for income tax purposes, is “allowed by this subtitle. . .[and] properly allocable to” net investment income. This is not that different from allowing deductions for NIIT purposes that may be limited for purposes of the alternative minimum tax, if the taxpayer were subject to that tax for the year. In our view, the reference to deductions "allowed by this subtitle" in section 1411 should not be given an overly mechanistic interpretation, where it would produce a result so clearly contrary, in our view, to what Congress likely intended.

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