New 3.8% Tax on "Net Investment Income" – IRS Issues Proposed Regulations

The Internal Revenue Service has issued Proposed Regulations under Section 1411 of the Internal Revenue Code providing guidance on the 3.8% additional tax that will be imposed beginning January 1, 2013 on the "net investment income" of certain individuals, estates and trusts. This surtax on unearned investment income was added as a part of the recently enacted health care reform laws.

Basics of the Tax

The new tax applies to individuals, estates and trusts with unearned "net investment income" in excess of certain amounts.

For individuals, the tax is equal to 3.8% of the *lesser* of (a) the individual's net investment income for the taxable year, or (b) the excess of the individual's modified adjusted gross income (AGI) for the taxable year over the threshold amount. The threshold amounts for individuals are generally $250,000 for joint filers and $200,000 for single filers.

For estates and trusts, the tax is equal to 3.8% of the *lesser* of (a) the estate's or trust's undistributed net investment income, or (b) the excess of the estate's or trust's AGI over the dollar amount at which the highest tax bracket begins for such taxable year (*e.g.*, $11,650 for 2012).

Net investment income is defined broadly to include gross income from interest, dividends, annuities, royalties, rents and capital gains, less any allocable deductions. Income (or capital gains from property) derived in the ordinary course of a trade or business is generally excluded—except that, notably, the tax will apply to any trade or business that is either (a) a *passive activity* with respect to the taxpayer or (b) a *trade or business of trading in financial instruments or commodities*. For purposes of the tax on net investment income, income from the investment of working capital is not treated as derived in the ordinary course of a trade or business and so will always be subject to the tax.

Net investment income does not include tax-exempt interest or distributions from qualified plans, including qualified pension, profit-sharing, stock bonus or eligible deferred compensation plans, IRAs and Roth IRAs, and others. Net investment income also does not include income that is otherwise subject to self-employment tax. Payments from non-qualified deferred compensation plans likewise generally fall beyond the reach of the tax, as income derived in the ordinary course of the trade or business of being an employee.

Affected Taxpayers

Because of the wide sweep of the tax, various groups of taxpayers will be affected in different ways. The Proposed Regulations provide extensive rules for applying the basic mechanics of the tax in a broad array of circumstances. As a result, the new tax and the Proposed Regulations implicate a variety of legal practice areas and affected Ropes & Gray clients should consider contacting an attorney who specializes in their particular area of concern.

- Individuals investing in securities and managers of funds that trade in financial instruments are directly affected and those with questions or concerns about the particularities of the Proposed Regulations relevant to securities, real estate, S Corporations or partnership interests should contact advisors in Ropes & Gray's tax and hedge fund groups.

- Private trusts investing in securities, as well as other types of investment assets, are directly affected by the new tax. Certain types of trusts are exempt from the tax, whereas others (*e.g.*, charitable remainder trusts) are subject to special rules. Individuals and families should contact their advisors in Ropes & Gray's private client group for advice on how trusts, as well as estate, gift and income tax planning arrangements, may be impacted and whether there may be ways to optimize planning in light of the new tax.
- Companies that compensate employees with awards that may generate net investment income and would like to understand the effect of the Proposed Regulations on their compensatory structures should contact advisors in Ropes & Gray's executive compensation and benefits groups.

For more information, please contact a member of one of the Ropes & Gray teams listed above, or your regular Ropes & Gray attorney.

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