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Ultimate Estate Planner:
<u>Form 8960 – The Net Investment Income Tax</u>

In 2013, a new tax planning focus area, the net investment income tax (NIIT), was added to the already long list of hot topics all trust and estate practitioners must understand-- charitable trusts, gain harvesting, loss harvesting, income smoothing strategies, income shifting strategies, asset protection trusts, tax-aware investing, decanting, portability, advanced strategies for clients with taxable estates, etc. While the NIIT is far from clear in some areas, parts of this new tax planning focus area have recently been clarified through the release of the NIIT Final Regulations and the Form 8960 draft instructions.

Form 8960: Overview

At first glance, draft Form 8960 does not look all that complex – it's only one page! However, upon closer examination, many of the lines include the infamous "*see instructions*" parenthetical (kind of similar to how the less-than-one-page-non-complex-looking Section 1411 [the NIIT] statute appeared until the release of the regulations). Fortunately, like the Section 1411 Final Regulations, the draft instructions for Form 8960 did provide some clarity.

Form 8960 is broken down into three parts:

- Part I – Investment Income;
- Part II – Investment Expenses Allocable to Investment Income and Modifications; and
- Part III – Tax Computation.

The draft instructions spend the first 5 pages providing guidance on some of the overall issues with the NIIT; including, "Application to Individuals," "Application to Estates and Trusts," and "Passive Activity." Furthermore, under "Passive Activity," the instructions provide guidance as to the "General Rules," "Trade or Business Activities," "Material Participation," "Rental Activities," "Real Estate Professionals," "Safe Harbor for Real Estate Professionals," "Re-characterization of Passive Income," "Special Rules for Certain Rental Income," "Treatment of Former Passive Activities," "Disposition of Entire Interest," "Economic Grouping," and "Disposition of Partnership Interest or S Corporation Stock." This part of the instructions really helps practitioners and taxpayers understand how those rules work under the NIIT; it provides a concise summary of the rule and its application under the NIIT.

Part I – Investment Income: Highlights

Part I, entitled "Investment Income," is made up of eight lines, of which line four has three subparts and line five has four subparts. Below are some of the highlights from the Part I instructions:

- *Line 4b – Adjustment for Net Income or Loss Derived in the Ordinary Course of a Non-Section 1411 Trade or Business*: This line is used to enter the net positive or net negative amount for certain items included in line 4a that are not included in determining net investment income (NII); for instance, net income or loss from a section 162 trade or business that is not a passive activity and is not engaged in a trade or business of trading financial instruments or commodities. Furthermore, this line is used to adjust for certain types of nonpassive rental income or loss derived in the ordinary course of a section 162 trade or business; for example, nonpassive net rental income or loss of a real estate professional where the rental activity rises to a section 162 trade or business, net rental income or loss that is a nonpassive activity because it was grouped with a trade or business under Reg. Section 1.469-4(d)(1), and net income that has been recharacterized as not from a passive activity under section 469 passive loss rules and is derived in the ordinary course of a section 162 trade or business (e.g., net income from property rented to a nonpassive activity). In sum, this line takes into account the adjustments for the real estate professional safe harbor, the self-rental rules, and more as was provided for in the final regulations.

- *Lines 5a-5d – Gains and Losses on the Dispositions of Property*: The instructions provide a two-page worksheet for assistance in calculating net gain or loss includable in NII.

- *Line 7 – Other Modifications to Investment Income*: Line 7 is used to report additional NII modifications to NII that are not otherwise specified in lines 1-6. For example, use line 7 to report additions and modification to NII such as: Section 1411 net operating loss, self-charged interest, deduction recoveries, distributions from estates and trusts, and more. The instructions also provide a deduction recoveries worksheet to determine the amount of recovery (if any) to include on line 7. In sum, similar to line 4b, this line takes into account more of the adjustments for certain rules provided for in the final regulations.

Part II – Investment Expenses Allocable to Investment Income and Modifications: Highlights

Part II, entitled "Investment Expenses Allocable to Investment Income and Modification," is made up of three lines, of which line nine has four subparts. Below are some of the highlights from the Part II instructions:

- The introduction explains that Part II is used to report deductions that are, predominately, itemized deductions. Further, if you do not itemize your deductions for regular income tax purposes, you may not for NIIT purposes. Lastly, it provides guidance on reasonable method allocations and items not deductible in calculating NII.
- Furthermore, to help with Lines 9 and 10, the instructions provide a two-page worksheet for the application of itemized deduction limitations on deductions properly allocable to investment income.

Part III – Tax Computation: Highlights

Part III, entitled "Tax Computation," is made up of ten lines. It is further split into two sections: "Individuals" (five lines) and "Estates and Trusts" (four lines, with lines 18 and 19 both having three subparts). Below are some of the highlights from the Part II instructions:

- *Line 18b – Deductions for Distributions of Net Investment Income and Deductions Under Section 642(c)*: The undistributed NII of an estate or trust is its NII reported on line 18a, reduced by the NII included in the distributions to beneficiaries deductible by the estate or trust under section 651 or 661, and by the NII for which the estate or trust was entitled to a section 642(c) deduction. The instructions further state that Reg. Section 1.1411-3(e) applies the class system of income categorization, generally embodied in sections 651 through 663 and related regulations, to arrive at the trust's NII reduction in the case of distributions that are comprised of both NII and net excluded income items.

- ❖ The instructions point the taxpayer to Form 1041, Schedule A, as it provides for a calculation of an estate's or trust's charitable deduction for regular tax purposes which can be used as a worksheet to calculate the amounts of NII allocable to charitable distributions. Furthermore, the instructions also point the taxpayer to Form 1041, Schedule B, as it provides for a calculation of an estate's or trust's income distribution deduction for regular tax purposes which can be used as a worksheet to calculate the income distribution deduction for NIIT purposes.

Conclusion

This article only briefly touches on some of the highlights of the newly released draft instructions for Form 8960 and the NIIT. In order for a practitioner to become knowledgeable enough to navigate through this new focus area of tax planning, much more time must be spent trying to understand Section 1411, the Final Regulations and Form 8960.