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**Lead Tax Report**


## **Income Taxes**


### **Inclusion of Net Loss on Draft NII Tax Form Could Benefit Taxpayers, Practitioners Say**

*By Lydia Beyoud*

The inclusion of the term "net loss" on a newly released draft form to be used to compute the net investment income tax on certain passive income could mark a policy turning point for the tax in advance

of the anticipated release of final regulations-with big implications for businesses in the rental real estate industry, a practitioner told BNA Aug. 8.

Draft Form 8960, Net Investment Income Tax-Individuals, Estates, and Trusts, issued Aug. 7 without accompanying instructions, applies to individual income derived from passthrough entities as well as from estates and trusts (153 DTR G-4, 8/8/13 ).

The draft form indicates how taxpayers will comply with the proposed rules (REG-130507-11) issued November 2012 (64 DTR G-6, 4/3/13 .

One of the most controversial aspects of the proposed rules has been the exclusion of net losses in calculating the amount of income subject to the 3.8 percent tax.

The statute under tax code Section 1411 refers solely to the inclusion of net gain attributable to the disposition of property for the purpose of calculating the income tax. The positions of the Internal Revenue Service and Treasury Department on the matter have generally been that a taxpayer may not take net losses from the disposition of property into account to offset other categories of investment income, Michael Grace, counsel at Whiteford, Taylor & Preston LLP, told BNA Aug. 8.

However, Line 5a of Part I of the form, on determining total investment income, mentions both net gain and net loss. This inclusion could be significant for all taxpayers, because it could allow them to reduce some of their passive income before calculating their NII tax liability, Grace said.

Though the draft form notes that it "does not reflect any public comments received on [the] regulations, and no inference should be drawn from any particular line item regarding the treatment of such item in the final regulations," the inclusion of losses could lead taxpayers to wonder whether the agency's policy position has evolved, Grace said.

"The devil will be in the details of the instructions and the final regulations; nevertheless, this form ... may intimate how [IRS is] leaning toward resolving particular issues," he said.

## **Jittery Over Uncertainty**

The Affordable Care Act added Section 1411 to the tax code in 2010. Among the section's provisions is the imposition of a tax on NII, or the unearned income or investments of certain individuals, estates, and trusts.

For individuals, the NII tax applies on income above certain thresholds, including \$200,000 single filers or \$250,000 for married couples filing jointly.

## **Wide-Ranging Impact**

Because the NII tax affects a large swath of businesses and industries, not least among them the rental real estate industry and investment management companies, the nuances of the draft form that could be better explained once the accompanying instructions-and final rules-are released could have important implications, Grace said.

The rules are so broad that dividends of all sorts will be subject to the reporting regime for those above the income thresholds, regardless of the particular industry, he added. As the number of passthrough entity returns filed with IRS continues to increase, more and more individuals will find themselves subject to the tax, he said.

The tax went into effect Jan. 1, 2013, but practitioners have told BNA that the uncertainty over the past several months about how the tax will be computed and reported has been a point of concern.

While the draft form sheds light on some matters, the lack of instructions-in addition to final regulations-only prolongs that uncertainty, they said.

## **Rents, Real Estate**

Another key area of concern with the rules, practitioners said, is the treatment of income from rents and real estate. The draft form seemingly adds to the complexity of this area, they noted.

Line 4a of Part I of Form 8960 refers to "rental real estate," while the statute subjects all rents to the NII tax, Grace noted.

This linguistic divergence could have big consequences, he said. Rental income could derive from any manner of personal property aside from real estate, including boats, power tools, or equipment, all of which would seem to be subject to the tax under the regulations, he said.

More general rental income beyond real estate could be covered somewhere else, such as the forthcoming instructions, but the specificity in this line of the form, "continues this overall theme that the manner in which the NII tax applies to rents seems pretty complicated," Grace said.

Adding to the complexity, Line 4a combines several categories of items, including these items as well as income from partnerships, S corporations, royalties, and other income, that will have to be separately determined before a taxpayer can determine the overall amount to insert on the line, Grace said.

"Presumably, the instructions will flesh out how to do all that," he said.

The uncertainties around the real estate and rental aspects of the tax are one reason practitioners,

including Grace, have urged IRS to include a self-contained section on rents in the final rules, he said.

"One of the challenges of the proposed regulations is that they cover rents in a rather fragmented way. There are examples buried throughout that cover this or that aspect; it would be a more user-friendly if they combined them into one section," he said.


## **New Terms for Trade or Business**

The draft form also includes a new term in Line 4b on net income or loss derived in the ordinary course of a "non-section 1411 trade or business," practitioner Jonathan Horn, told BNA Aug. 8.

This term presumably refers to a business in which an individual materially participates, because it is on an income adjustment line, but practitioners cannot be certain without further clarification from the Service, said Horn, a certified public accountant, chartered global management accountant, and sole practitioner based in New York.

The new term only adds to other terms that are separately-and sometimes ambiguously-defined in the Section 1411 regime, along with "material participation," "active trade or business," and "rental" income, Horn said.

"My guess would be that they created a new phrase because of this whole problem with rental real estate," said Horn.

Rents could escape the tax under the proposed regulations if a taxpayer qualifies as a "real estate professional" under Section 469(c)(7) and if the particular rental activity is not a passive activity, but determining at what level a taxpayer can be considered such a professional can be difficult, one of IRS's primary drafters of the proposed rules, David Kirk, said in January (19 DTR G-11, 1/29/13 ) .

There are 11 types of previous real estate professional trades or businesses under Section 469(c)(7)(c), that could fall along a spectrum of material participation, Kirk, an attorney with the IRS Office of Associate Chief Counsel, Passthroughs and Special Industries, said.

"We've gotten many comments so far, formal and informal, to say 'please define trade or business of rental real estate,' and I'm not sure anyone can. It's sort of like 'you'll know it when you see it,' " Kirk said.

## **Subtraction Method**

Another area of additional complexity is the draft form's emphasis on the use of a so-called subtraction method in determining investment income on Lines 4a through 4c, Grace said.

In its simplest form, this method, outlined in the proposed rules, requires taxpayers to take all income

potentially subject to the tax, subtract from that figure any items that clearly fall outside of the NII tax's scope, to derive the amount that is subject to the tax, Grace explained.

"In my own opinion, it's a method that's more complicated than necessary," he said. IRS could simplify the final rules by just tracking the statute and clearly defining the categories of included income, Grace added.

### **Is Form 8960 Adequate for IRS Audits?**

One surprising aspect to how the draft form is structured is the requirement to report all income on one line, make an adjustment on another line for non-net investment income, and provide a total amount on a third line, Horn said.

Horn provided the hypothetical situation of a taxpayer invested in four partnerships, two of which he materially participates in, while acting as a passive investor in a third and only materially participating in one line of business in a fourth partnership that contains two lines of business.

When IRS looks at the taxpayer's reported income from these activities, "they will have no idea which activities he's claiming to be materially participating in," Horn said.

This aspect could become important as IRS tries to audit Forms 8960 in the future, he said.

Based on the way the draft form is currently set up, and without the instructions, IRS appears to lack the information necessary to determine whether or not to spend resources on audit activity in this area, Horn said.

"I expected to see something from Schedule E, [Supplemental Income and Loss]" to Form 1040, which breaks income reporting down into specific categories, Horn said. Taxpayers and practitioners will already be engaging in breaking down their income in a way similar to that reported on Schedule E in order to determine their NII tax, so it seems odd that IRS would not provide for this information on the form, he said.

"Everything the IRS and Congress has been doing with information reporting has been to increase the amount of detail they have in order to use the power of [their] system to try to figure out a smarter way to audit," Horn said.

Form 8960 seemed like another opportunity to continue this pattern, but the draft indicates that they may not pursue that path in this area, he said.

### **Weighing Compliance Against Data**

In limiting the draft form to just one page, IRS may have opted for a trade off between limiting reporting complexity but also potentially deferring a number of details and computations to the instructions, which could be useful in helping determine cause for an audit, Grace said.

"I can envisage a situation where the instructions make a worksheet of the amount to enter on Line 4a," he said. If that ends up being the case, the worksheet could be fairly complicated, as it would encompass a number of different income categories, he said.

"It will be important for taxpayers to prepare themselves for a potential audit-to take the time to work through those worksheets carefully, but also make sure they retain [them] in their files for an adequate period of time," because IRS could ask taxpayers to "show their math" in determining how they reached the figure reported in Line 4c, Grace said.

The adjustment for disposing of an active interest in a partnership or S corporation on Line 5c could be another possible area of audit sensitivity, Grace said.

"Because the statute refers to a complex calculation" for this line item, if IRS ramps up its audit coverage of partnerships and passthrough entities, "this computation could be on the inquiry list," he said.

### **Coding System for Adjustments**

IRS could consider adding a coding system, such as the one used on Form 8949, Sales and Other Dispositions of Capital Assets, to identify the types of adjustments made on Form 8960, Horn said.

"There's an opportunity to get more information from the taxpayer, who already has to generate it for their own calculations," he said.

The Service already does this for corporate returns in order to improve its allocation of audit resources, he noted.

"Because this is a new area, if you start with the codes right up front, you'll find out maybe that certain types of adjustments are common and we don't need to worry about [them], or they're too common, and being used more frequently than anticipated," Horn said.

### **Behind the Scenes**

One of the reasons the draft form may have been issued without its most critical component-the instructions-is the different timelines that IRS divisions frequently work on, said Grace.

"What often happens with a hot project...is you have [the] Forms and Publications [division] trying to meet release printing deadlines for the 2013 filing season, and at the same time you have the regulations

drafters [who are] still resolving policy issues and drafting rules, Grace said, drawing from his experience as a former IRS employee and one of the principal authors of 1988 temporary regulations governing passive loss rules.

Releasing the form with so many disclaimers could help Forms and Publications move their process along "but not get too far ahead of the actual rules and regulations," he said, though he added he was simply conjecturing.

This division has the added pressure of getting documents to printers and software programmers to allow them adequate lead time to adjust their software for the upcoming filing season, he said.

The next key NII tax development will be the instructions, particularly with regards to income adjustments, Steven Schneider, a partner at Goulston & Storrs, told BNA Aug. 7.

Though the form conforms closely to what one might expect from the proposed rules, the latter are so massive that "the way they get that complication dealt with on such a simple form is [to roll everything] into that adjustment," he said.

In issuing the draft form, "they've done the easy part," Schneider said.

"The instructions will be trying to take that massive regulation, which is only proposed, and put it into something that an accountant can mechanically follow when doing the tax return. That's not going to be easy," he said.

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