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New net investment income tax regulations allow high-income taxpayers to plan now for 3.8% tax

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The proposed regulations on net investment income (NII) allow high-income taxpayers to engage in more precise year-end planning, taking into consideration the 3.8% Medicare Contribution Tax (MCT), which is set to go into effect in 2013.

General planning

Planning for the imposition of the 3.8% MCT on investment income cannot be done in a vacuum. The 3.8% tax is likely to be just one component of a significant overall tax increase on the take-home pay, after-tax returns and, ultimately, the disposable cash flow of high-income taxpayers. Therefore, affected taxpayers who are trying to make a holistic assessment of what these changes mean for them and what they should do in response might want to do the following:

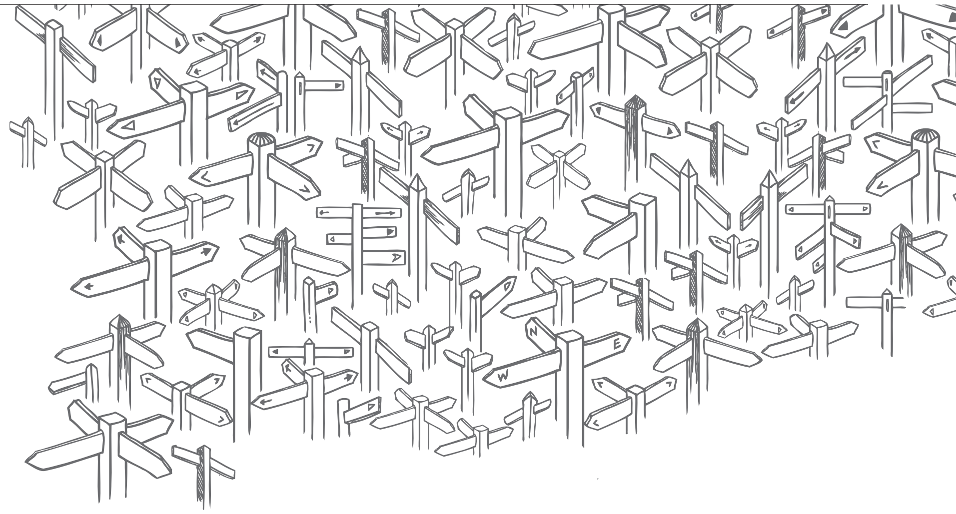
1. **Project their income, exemptions and deductions for 2012 and 2013 —** The projection/comparison will help taxpayers assess the benefits of accelerating or deferring income and deductions as part of their year-end planning. The projection/comparison will also help taxpayers appreciate the full effect of the changes scheduled for 2013 and allow them to craft a tactical response in terms of adjustments to their compensation planning and investment planning.
2. **Project how long their money will last under certain assumptions (or revisit prior projections) —** Based on the projections, some taxpayers might find that they have to compromise on or postpone some goals. Other taxpayers might decide to increase their rate of investing to meet their goals.

Investment planning

Because the 3.8% MCT could be an additional drag on after-tax returns for taxable investments, taxpayers might want to consider the following:

1. **Revisit their asset location —** It has always been important to match the tax characteristics of an investment with the tax characteristics of the account where it is held. However, at 15% tax rates on investment income and capital gains, imprecision in asset location hasn't had a significant downside. This is no longer the case. It will now be much more important for taxpayers to look at what they own in such tax-deferred accounts as their 401(k)s and IRAs versus what they own in their taxable accounts. As a general rule, they'll want to hold investments that generate current ordinary income in the deferred accounts and hold investments that generate minimal current income in their taxable accounts. Of course, a given taxpayer's asset allocation might not seamlessly lend itself to such a general rule, so more planning and investment "packaging" might be appropriate.
2. **Revisit the tax implications and management expenses associated with each component of their portfolios —** By way of example, some taxpayers might be able to achieve their objectives more tax efficiently by using broad-based index funds in their taxable accounts rather than actively managed funds. Or, as we'll discuss in a moment, they might consider owning their funds in a deferred annuity or cash value life insurance policy. In any case, tax planning can only do so much. Therefore, unless a taxpayer can somehow levitate gross returns, the only club left in the bag is expense control, which taxpayers might want to address with their financial advisors and money managers. This would be especially true for any taxpayer who uses more than one money manager and would like to know that the managers are in sync in terms of asset allocation, asset location, tax positioning of the portfolios and expense control.
3. **Consider vehicles that offer tax conversion and/or deferral —** In light of higher tax rates on income and gains and the 3.8% MCT, two tax strategies that are likely to make sense for many taxpayers are conversion of ordinary income to tax-exempt income and deferral of income to a later tax year. Conversion is most often associated with tax-exempt bonds, the interest on which will not be subject to the MCT. Deferral is often associated with deferred annuities and cash value life insurance.

Deferred annuities and cash value life insurance offer the same tax-deferred build-up. But then some sharp differences appear. With the deferred annuity, withdrawals are ordinary income to the extent of gain in the contract, and the income will be subject to the MCT. If the owner is not 59 1/2, there is also a 10% penalty tax, with exceptions. The death benefit is taxable income to the beneficiary. But deferred annuities might be attractive to many taxpayers because they will be



able to defer their withdrawals until a year/age when they will be in a lower bracket and no longer subject to the MCT. Of course, deferred annuities also offer an array of contractual benefits that can be very appealing to many taxpayers/investors.

Cash value life insurance offers both deferral and conversion, in the sense that the policyholder can access the cash value through tax-free partial withdrawals and policy loans. And the death benefit is tax-free to the beneficiary. Arguably, the tax benefits of life insurance are going to be even more valuable in the years ahead, i.e., no income tax and no Medicare tax. Interested taxpayers should first check if they can add to (and perhaps restructure) an existing policy. If they cannot, then they should work with their agents to design the new policy for maximum cash accumulation and efficient cash withdrawals.

Passive activities

Because passive activities will be subject to the MCT, owners of interests in pass-through entities (i.e., partnerships, S corporations and limited liability companies) may want to reconsider their participation level in these entities — possibly increasing their participation level such that the activity is not a passive activity as to them. Individuals considering the possibility of increasing participation need to consider the effect of a change in the character of an activity from passive to active on their overall passive loss position (including passive loss carryovers). Another possible way to convert passive activities into non-passive activities is to regroup the activities. The proposed regulations allow taxpayers to regroup their activities in the first tax year beginning after 31 December 2013, in which the taxpayer meets the applicable income threshold set forth in the proposed regulations and has NII. The preamble further provides that taxpayers may regroup their activities in reliance on the proposed regulations for any tax year that begins during 2013 if Section 1411 would apply to the taxpayer in that tax year. Thus, a taxpayer may regroup activities effective for 2012 in reliance on the proposed regulations.

In reconsidering their participation level in these entities, owners will need to also consider the effect that such participation will have on their self-employment (SE) income (which includes an additional contribution amount equal to 0.9% if the threshold levels are met (same as the threshold levels for the application of the MCT to NII)). Active partners in a partnership or limited liability company are generally subject to SE tax on earnings. However, due to the deductibility of a portion of the SE tax under Section 164(f), the after-tax cost of being subjected to the SE tax on trade or business income may be lower than that of the MCT. For S corporation owners, earnings are not currently subject to SE tax unless paid as wages. Thus, active participants in business operations of S corporations would not owe either SE tax or MCT on trade or business income.

Trusts and charitable contributions

With regard to charitable deductions allowed to trusts under Section 642(c), the proposed regulations allow charitable deductions to be taken into consideration in determining NII. Before the proposed regulations, it was unclear as to whether a trust would get the benefit of the charitable deduction in determining NII, as it was questionable whether such a deduction was "properly allocable" to an item of income. This is especially beneficial to non-grantor charitable

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lead trusts. This benefit is not afforded to individuals who make charitable donations.

With regard to charitable remainder trusts, the proposed regulations apply the NII rules to distributions to non-charitable annuity or unitrust recipients. Thus, trustees of these trusts may want to consider whether they should do year-end planning, much like that of an individual, to take advantage of the fact that the MCT does not apply in 2012, nor will it apply to the future distribution of income and/or gains from a CRT that were recognized before the end of 2012.

Conclusion

The proposed regulations give taxpayers a lot to think about before the end of the year. Taxpayers need to plan now because, regardless of what income tax rates will be in 2013, tax rates are clearly going up on NII.

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This Alert was prepared to present time-sensitive information affecting our clients. Recipients of this publication should promptly review and consider the effect of its contents on the clients they serve. The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.

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