



Net Investment Income Reporting by Partnerships



Beginning in 2013 individuals, estates and trusts are subject to a surtax of 3.8% on net investment income above statutory threshold amounts (\$250,000 for joint filers or surviving spouses, \$125,000 for a married individual filing a separate return, and \$200,000 in any other case).

Net investment income ("NII") is generally unearned income from investments less investment expenses and includes, but is not limited to, interest, dividends, net capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities (e.g., trader hedge funds), and businesses that are passive activities to a taxpayer. Investment income does not include income subject to self-employment tax, distributions from certain retirement plans, such as qualified employer plans and individual retirement accounts, or tax-exempt income, such as interest from state and other municipal obligations. There has been a lot of guidance issued on the net investment income tax ("NIIT") and the tax has resulted in a new IRS form, Form 8960, Net Investment Income Tax – Individuals, Estates, and Trusts. Applying the new rules will be

challenging to those subject to the tax and individuals, estates, and trusts with interests in partnerships will need additional information not typically reported on Schedule K-1 to calculate NII. This article focuses on the additional reporting required by partnerships (which includes LLCs and S Corporations for this discussion) and unique issues facing investment partnerships.

The instructions for 2013 Form 1065, *U.S. Return of Partnership Income*, provides guidance on the information partnerships are required to report to their partners regarding NII. Schedules K and K-1 of Form 1065 have been updated to include new code 20Y (code 20U for Form 1120S) to report information that may be relevant for partners to compute their net investment income. It is important to note that the partnership is **not required** to calculate net investment income allocable to each partner, but only to provide such relevant information (not otherwise identifiable on Schedule K-1) which is necessary for the partner to complete Form 8960 and calculate his or her net investment income.

Partnerships must inform their partners of adjustments to income, expense, gains, and losses to the extent such items are excluded from the calculation of NII. Generally, most adjustments will be to separate trade or business activity from investment activity. The draft instructions to Form 1065 and Form 8960 provide examples of ‘relevant information’ that is needed by an individual or trust who receives income from a partnership to properly calculate its NII. The portion of a gain attributable to the disposition of property held in a trade or business, for example, would need to be disclosed to a partner who must then reduce the amount of flow-through gain from the partnership includible in NII.

For the majority of hedge fund and private equity investors, nearly all of the flow-through items reported on Schedule K-1 will be included in NII since net income or loss from a trade or business in which a taxpayer does not materially participate and net income or loss from the trade or business of trading in financial instruments and commodities are specifically included in NII. If an investor in a fund receives an allocable share of net income or loss from a (Internal Revenue Code Section 162) trade or business in which the investor materially participates, an adjustment should be made to remove such income or loss from the calculation of the investor's NII. It would, therefore, appear that partnerships would need to disclose on each partner's Schedule K-1 an itemized list of the allocable share of net income or loss from every trade or business in which the partnership directly or indirectly invests.

Interests in CFCs and PFICs

The regulations provide that income from controlled foreign corporations (“CFC”) and passive foreign investment companies (“PFIC”) that elect to be treated as qualifying electing funds (“QEF”) is includible in the calculation of NII. However, the timing of when income from CFCs and QEFs is recognized is different for income tax purposes and NIIT because distributions received from a CFC or QEF may be included in NII even if not included for income tax purposes. An individual may make an election to include income from a CFC and QEF as part of NII at the same time as they would for regular tax purposes, and as such, any distributions from a CFC or QEF that are not treated as dividends for income tax purposes will not be included in NII. The election is made by checking the check-box for “Regulations section 1.1411-10(g) election” on Form 8960 and attaching a statement to your return that identifies each CFC and QEF for which an election is made and providing the EIN or reference ID number of the CFC or QEF. Absent an election, a taxpayer's tax basis in a CFC and QEF may be different for income tax purposes versus NII and must be tracked to report adjustments for NII at the time of disposition.

Domestic partnerships that are U.S. shareholders of a CFC or QEF can make the same election to treat income from a CFC or QEF as part of NII in the same tax year as such amounts are included in income for regular tax purposes.

Domestic partnerships can make the election for taxable years beginning in 2014. An election can be made for taxable years beginning before 2014 only if consent is obtained from all the partners and beneficial owners of the partnership. Provisions contained in the limited partnership agreement may permit the general partner to make the election on behalf of its limited partners.

If a domestic partnership does not make an election, it must provide information related to such income inclusions from each CFC and QEF for which it directly or indirectly has an interest and must also provide information related to the following:

- distributions from a CFC subject to NIIT;
- distributions from a QEF subject to NIIT;
- the amount of additional gain or loss derived with respect to dispositions of the stock of CFCs and QEFs that is taken into account for NII; and,
- amounts that are derived with respect to the disposition of the stock of CFCs and QEFs and included in income as a dividend under Sec. 1248 for Sec. 1411 purposes.

Additionally, partners in a partnership that have a direct or indirect ownership in a PFIC for which a QEF election was not made must be provided with information, on an entity-by-entity basis, relating to excess distributions made by the PFIC and gains or losses derived from disposition of PFIC stock. Investment partnerships with many direct or indirect interests in PFICs will find these requirements very burdensome.

IRS has provided certain additional guidance in the final and newly proposed regulations released in December 2013 to assist taxpayers with the calculation of NII with respect to various specialized transactions and situations. A provision in the final regulations clarifies that net losses from investor and trader funds, including those making elections under Sec. 475(f), are includible in NII. Previous guidance seemed to indicate that excess losses from the business of trading in financial instruments and commodities would be disallowed for NII purposes even if allowed for regular tax purposes. The newly proposed regulations provide for the exclusion of partnership guaranteed payments for services from NII, even when such payments are not subject to self-employment tax. According to the proposed regulations, payments to retiring or deceased partners that represent such partner's share of partnership income, other than from trading in financial instruments and commodities, fall under the trade or business exclusion from NII. Interest or other investment income from working capital included in such payments, however, would be includible in NII.

The NIIT has added a new and significant element to reporting requirements for individuals, estates, trusts, and pass-through entities. Although it has not yet been fully vetted in practice and its true impact has yet to be determined, the NIIT may turn out to be as complex as the alternative minimum tax given the nature and complexity of its reporting requirements. Investors in alternatives and the partnerships themselves will be put to task during the upcoming filing season to provide all relevant information needed by their partners to properly compute net investment income. Contact a WTAS professional today to help you understand how the new NIIT and reporting requirements will affect you and your business.





BALTIMORE BOSTON CHICAGO DALLAS
GREENWICH HARRISBURG HOUSTON LOS ANGELES
NEW JERSEY NEW YORK CITY PALO ALTO PHILADELPHIA
SAN FRANCISCO SEATTLE WASHINGTON, D.C. WEST PALM BEACH

© WTAS LLC 2014 | 100 First Street, Suite 1600, San Francisco, CA 94105
wtas.com | [Privacy Policy](#) | [Terms & Conditions](#) | [Disclaimer](#)



Tax Tips for Collectors, Investors, and Dealers



The tax implications of buying and selling tangible personal property such as art, coins, and classic cars are more complicated than they appear. At its most basic level, the motivations and actions of the taxpayer shape the tax consequences.

When buying and selling these types of items, an individual can act as a collector, an investor, or a dealer and the tax implications are different for each. The lines between these categories are not exactly clear and the treatment can be different for each transaction.

Collecting For the Enjoyment of Owning

A collector is an individual who buys tangible property primarily for the purpose of personal enjoyment and pleasure. This individual does not buy and sell in a businesslike manner and does not have a profit motive first and

foremost. As an end-user of the goods, the collector pays sales tax on his or her purchases. From an income tax perspective, deductions such as insurance, upkeep and storage are significantly curtailed under the Section 183 hobby loss rules, while net losses are not allowed at all. Gains, however, are taxable and are subject to preferential long-term capital gains rates if the property is held for more than one year. Note that collectibles held long-term are taxed at a rate of 28% plus the 3.8% surtax.

A Dealer Who Loves to Trade

A dealer is an individual engaged in the trade or business of selling personal property. To be considered in a trade or business, the individual's activity should consume a significant amount of time and generally sustain his or her livelihood. There should be substantial and continuous selling activity where profit is the primary motive. A dealer generally does not pay sales tax on his or her purchases as these purchases constitute inventory and are held for resale. From an income tax perspective, all business related costs are deductible, but sales of appreciated property do not qualify for the preferential long-term capital gains tax rates. Rather, all income is taxed at applicable ordinary income rates (currently 39.6%). Losses on sales are deductible against other income.

Investing Over the Long Haul

An investor is a person who buys and sells property with a profit motive in mind, but whose activity does not rise to the level of a dealer. The investor is more interested in capital gains from long-term appreciation as opposed to rapid gains from turning over property quickly. While investors do pay sales tax on purchases, they enjoy the right to deduct expenses relating to the item. Expenses, however, are considered investment expenses and are itemized deductions that can be deducted to the extent they exceed 2% of adjusted gross income. As with collectors, qualifying sales are taxed at the preferential long-term capital gains rates. Unlike collectors however, investors can claim capital losses and 2% deductions, as limited.

Why One Category Over Another

It is not uncommon for a taxpayer to claim one status over another because of the potential for a reduced tax burden. For instance, a collector may wish to avoid a disallowance of losses by claiming the status of investor. An investor may wish to claim the status of dealer if he or she wishes to deduct losses against ordinary income rather than generate potentially unusable capital losses. A dealer, alternately, may want to claim the status of an investor or collector to utilize the long term capital gains tax rates as opposed to generating ordinary income.

What Do the Courts Have to Say?

The courts have provided guidance regarding how they evaluate which category a taxpayer belongs in. There are a number of factors that the courts examine and no single criterion is in and of itself determinant.

1. ***Frequency and Regularity of Sales***

The first and one of the more important factors that a court will evaluate is the frequency and regularity of sales. Typically, a large volume of sales would suggest that the taxpayer is involved in dealer activities. Investors and collectors do not sell large volumes on a regular basis. Their sales are more isolated and intermittent.

2. ***Substantiality of Sales***

Another important factor is the substantiality of sales. Sales that generate large profits as a result of capital appreciation as opposed to the taxpayer's efforts are more indicative of an investor or collector

than a dealer. This factor is looked at in conjunction with the previous factor to get a sense of how often the individual conducts sales and the size of the profit.

3. ***Duration of Ownership***

In general, the longer that a piece of property is held, the more likely that it is being held by a collector or investor than a dealer. Dealers tend to turn over their inventory quickly. Investors and collectors usually hold property for the long term.

4. ***Sales and Advertising Effort***

Dealers, by their nature, hold their property for sale and primarily derive their income from the profits so they put significant effort into sales and advertising activity. Investors and collectors usually do not conduct regular sales efforts. They often will have unsolicited sales or only put effort into selling once they have decided their objectives have been met.

5. ***Intent at Acquisition***

The courts will evaluate the original purpose of each acquisition. This does not preclude the owner from changing their intent during the holding period, but additional evidence will be needed to support the reason for the change. A dealer's intent is to sell property quickly and for a profit. The investor will have a longer term horizon for making a profit. The collector will primarily buy an item for their personal enjoyment and pleasure with a limited profit motive.

It is important to note that a taxpayer can be in more than one category with respect to buying and selling similar property. For instance, a coin dealer can be a dealer with respect to coins sold by his business, but an investor in coins that he or she owns separately.

6. ***Segregation of Property*** Comingling of dealer property with investment and collector property will weigh heavily against a taxpayer seeking favorable treatment. Segregation physically and the maintenance of separate records will help to demonstrate the divergent intents of the taxpayer with respect to the separate items sold. Keeping investments in secure storage, collection items on display in your home, and business inventory in a store will help illustrate how the taxpayer has different intents with each item.

Conclusion

Though none of these criteria is in and of itself conclusive, assessing the factors together leads to a determination of which status is most applicable. Even in complex situations where a taxpayer may claim multiple statuses, proper planning on the part of the taxpayer can lead to favorable tax results. Because of the nuanced criteria involved, it is advisable to consult with a tax expert to provide the greatest chance for the desired tax status.



BALTIMORE BOSTON CHICAGO DALLAS
GREENWICH HARRISBURG HOUSTON LOS ANGELES
NEW JERSEY NEW YORK CITY PALO ALTO PHILADELPHIA
SAN FRANCISCO SEATTLE WASHINGTON, D.C. WEST PALM BEACH



Public companies get unexpected surprise during audits of their tax provisions



Public companies are in crunch time for their 2013 year-end audits, annual reports and Q1 reporting.

Word on the street is that CFO's and corporate controllers have been commenting that their external auditors are requesting more documents and details than usual on every aspect of financial reporting, including the area of accounting for income taxes. These new and unanticipated demands are adding time, cost and confusion to the audit process.

The more rigorous audits are in reaction to an alert issued from the government accounting watchdog. On October 24, 2013, the Public Company Accounting Oversight Board ("PCAOB") warned that it had observed a number of deficiencies in audits of internal controls over financial reporting, including the area of income taxes. These internal controls are important to a company since they act as a company's first line of defense against fraud and financial

mismanagement.

The PCAOB warnings have pushed audit firms to make rapid changes to test management's oversight controls. For example, in the past, the audit firm's focus may have been to note a management sign off. Now auditors are requesting more documentation, going line by line over budgets, projections, etc., and sitting in on meetings to observe the internal controls over tax in action. In addition, the auditors are meeting with company personnel and consultants to fully understand their analysis behind their conclusions.

Auditors are spending more time analyzing the details and documentation that companies maintain to challenge the companies' conclusions on transactions. For example, attempting to determine if the documentation provides that the transaction has real financial substance or is merely designed to achieve a tax result.

Such scrutiny will bring a new sharper focus on the company's ASC 740 tax team to insure such team, including outside consultants, have the background, depth, and capabilities to assess the various tax treatments of domestic, multistate, and international exposures (such as the value added tax). In addition, the tax provision team must have a strong background in ASC 740 financial reporting, footnote disclosures and related issues. An SEC public registrant clearly wishes to avoid the restatement of financial statements for any tax items including deficiencies of internal controls over tax, and of course, any material weaknesses.

Bottom line is that due to the increased scrutiny by the PCAOB over audit firms on substantiating documentation and effective internal controls, including those covering the tax function, public companies will likely have much more substantial requests for documentation. It is imperative that a company has a qualified tax team to ensure both the ability to reach proper conclusions and the ability to provide comprehensive documentation supporting the positions taken.



BALTIMORE BOSTON CHICAGO DALLAS
GREENWICH HARRISBURG HOUSTON LOS ANGELES
NEW JERSEY NEW YORK CITY PALO ALTO PHILADELPHIA
SAN FRANCISCO SEATTLE WASHINGTON, D.C. WEST PALM BEACH

© WTAS LLC 2014 | 100 First Street, Suite 1600, San Francisco, CA 94105
wtas.com | [Privacy Policy](#) | [Terms & Conditions](#) | [Disclaimer](#)



The Importance of a Capital Sufficiency Analysis in Retirement Planning



Today's Retirement Challenges

The primary goal of retirement planning is to accumulate enough financial capital to last throughout retirement while funding all of one's goals and objectives. Unfortunately, retirement planning in today's environment has become more difficult than ever for a variety of significant reasons. First, private employers have been shifting away from defined benefit retirement packages (such as pension plans) and into defined contribution plans where employees bear all of the investment risks and are responsible for managing their own retirement accounts. Unlike pension plans, which guarantee a certain payment every year, defined contribution plans create more uncertainty as to how much will be available during retirement. Furthermore, the average life expectancy has risen dramatically over the last two decades, increasing the risk that retired individuals will outlive their financial assets. Finally, the volatile equity market over the past fifteen years and the persistent low interest rates in the fixed income market over the past five years have significantly affected the values of investors' portfolios and may have negatively

impacted their retirement plans.

Based on these challenging issues, retirement planning is more difficult and more important than ever. Although individuals cannot control these challenges, they can take certain steps to place themselves in the best position to meet their goals. One effective tool every investor should consider is putting their current financial assets through a capital sufficiency analysis.

A Framework for Evaluating Your Financial Strength

A capital sufficiency analysis is the process of determining the likelihood that an investor will have enough financial resources to last their entire life. More specifically, the analysis is used to evaluate whether an investor's current and future financial capital will allow for the achievement of all financial goals and objectives, which can include everything from meeting basic lifestyle needs and health care costs to leaving a legacy for heirs and philanthropic bequests.

The process of completing this type of analysis starts with a current balance sheet, an estimate of all cash flows in current and future years (including everything such as taxes and modest social security estimates), a retirement age and life expectancy, and overlaying capital market assumptions such as the rate of inflation and the expected rate of return on the portfolio (this will include a distinction between retirement accounts and non-retirement accounts which have different return expectations due to different tax considerations). When projecting these variables into the future, one can see how stable their balance sheet is and whether or not it is projected to run out early.

Of course, the variables involved in estimating events in the distant future mean the results of an analysis should only be used as a general frame of reference, as capital market expectations often do not materialize as projected and the expected return used in a forecast may not accurately reflect volatility involved in the markets (i.e., a portfolio may significantly underperform in certain years but will statistically average a certain return in the long-run). Most of the inputs used are only assumptions, such as life expectancy, living expenses and tax rates, so a capital sufficiency analysis can only provide a base case framework since there is no way to know all of the variables precisely.

The Benefits of a Capital Sufficiency Analysis

The results of a capital sufficiency analysis allow investors to make more educated and thoughtful financial and wealth planning decisions. It creates the opportunity to plan ahead for any potential cash shortfalls and to design an appropriate strategy to mitigate risks. Recommendations will be identified depending upon the outcome of this forecast, such as the need to save more or spend less, to stay employed longer, or to revise the allocation of one's portfolio to take on more or less risk in hopes of earning a return more in line with the financial plan. The earlier these types of changes are made, the more impactful they can be over the long-run.

The analysis should be re-evaluated periodically. This will measure the effect of improvements that have been implemented following a previous forecast. It will illustrate what progress has been made and if anything has changed significantly that should be addressed.

A capital sufficiency analysis can also be used to address questions such as how much spending one can sustain on an annual basis given their current portfolio size and strategy, or alternatively, what rate of return is needed in order to achieve a target annual spending rate. The forecast can be customized to show a variety of different solutions.

By providing a clearer picture of one's financial plan, a capital sufficiency analysis can result in more peace of mind. Many delay focusing on their retirement plan as they are preoccupied with the demands of everyday life. Some may even be apprehensive of what this type of analysis might reveal. However, whether the results of the analysis are pleasing or disconcerting, it should resolve a lot of the uncertainty about one's financial plan and identify strengths and weaknesses, providing opportunities to modify behavior and expectations. For those who have been diligent in their planning, it is quite possible this analysis shows that sacrifices today are disproportionately outweighing success in the future. Investors often find that they are in a much better position than they originally thought and that they may be taking on more risk in the portfolio than needed.

In conclusion, a capital sufficiency analysis can be a very helpful tool in financial and wealth planning decisions. It provides an estimate of how prepared investors are for meeting all of their financial goals and objectives, and the results can reveal any necessary changes that should be implemented to put themselves on the right track. It is never too early to start planning for retirement, and a capital sufficiency analysis is a great first step to take control of one's future.

WTAS routinely provides capital sufficiency analyses and recommendations for clients. If you have an interest, or if you have any other questions relating to this newsletter article or your investment portfolio, please contact your WTAS investment consultant.



BALTIMORE BOSTON CHICAGO DALLAS
GREENWICH HARRISBURG HOUSTON LOS ANGELES
NEW JERSEY NEW YORK CITY PALO ALTO PHILADELPHIA
SAN FRANCISCO SEATTLE WASHINGTON, D.C. WEST PALM BEACH

© WTAS LLC 2014 | 100 First Street, Suite 1600, San Francisco, CA 94105
wtas.com | [Privacy Policy](#) | [Terms & Conditions](#) | [Disclaimer](#)