

# The Net Investment Income Tax: Installment Sale Election



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For taxable years beginning after December 31, 2012, many taxpayers will be subject to a new tax under Internal Revenue Code §1411. Section 1411 imposes a 3.8% tax on net investment income (NII) of individuals, estates, and trusts with income above certain statutory threshold amounts (\$200,000 for single taxpayers and \$250,000 for joint filers). For individual filers, NII tax is equal to 3.8% of the lesser of their total NII for the taxable year or their modified adjusted gross income above their threshold amount. Trusts and estates are subject to the 3.8% NII tax on the lesser of their undistributed net investment income for the taxable year or the amount of gross income taxed at the highest tax bracket for the taxable year.

Net investment income is defined as investment income less any deductions allocable to such income and includes gross income from interest, dividends, annuities, royalties and rents (other than income derived in an active trade or business), and net gain from dispositions related to passive activities. NII also includes income from the investment of working capital, income from limited partnerships or from pass-through entities in which the taxpayer does not materially participate.

Although the NII tax covers a broad range of income sources, both active and passive taxpayers can take advantage of *opportunities* to minimize their exposure under §1411 by making certain elections.

The Proposed Regulations allow taxpayers who entered into installment sales prior to the effective date of §1411 to elect into special rules that may lower the NII tax on future installment sale proceeds received.

An installment sale is the disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs. Under the installment sale method, a taxpayer recognizes installment sale income from the payments

received in each taxable year based on the proportion of gross profit to the total contract price. Unless a taxpayer elects out of installment sale treatment, certain sales or dispositions of partnership interests or S Corporation stock at a gain will be treated as installment sales.

Generally, partnership or S Corporation interests are not considered property held in a trade or business and as a result, the gains are considered net investment income – regardless of whether the transferor materially participated in the activity. Proposed Regulation §1411-7 provides for an adjustment to the gain or loss from the disposition of a partnership interest and S corporation stock in determining NII. The adjustment is made in order to put the taxpayer in a similar position as if the partnership or S Corporation had sold its underlying property at fair market value immediately prior to the disposition of the interest.

Two criteria must be met in order to make the §1411-7 adjustment. First, the partnership or S Corporation must be engaged in one or more trades or businesses, and, second, the transferor taxpayer must be engaged in at least one non-passive trade or business with respect to the disposed interest. If these criteria are met, §1411-7 enables the taxpayer to bifurcate its share of partnership gain between that which is subject to and that which is exempt from the NII tax.

These Proposed Regulations provide that in the case of a disposition of a partnership interest or S corporation stock in an installment sale, the adjustment to net gain is computed in the year of the disposition. The gain and adjustment are deferred and recognized proportionately in future years when the cash payments are received. Since the adjustment is computed in the year of disposition, it generally is not available for pre §1411 effective date installment sales unless an election is made. Absent this election, the full amount of the gain on installment sale proceeds received in taxable years beginning after December 31, 2012, would be taxable as NII.

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Taxpayers can make an affirmative, irrevocable election to apply the Proposed Regulations §1411.1-7 to installment sale gains that are attributable to pre-effective date disposition. This election allows taxpayers that sold a partnership interest or S corporation stock in an installment sale before the effective date of §1411 to be treated similarly to taxpayers that sell these interests after the effective date. Taxpayers will be able to adjust their gains on installment sales and limit the application of the NII tax solely to net gains that would otherwise be subject to §1411 if the partnership or S corporation disposed of its property.

The election to apply §1411 to a pre-§1411 effective date installment sale must be made on a timely filed (including extensions) original or amended return and must include a statement of adjustment. The election must be made for the first taxable year beginning after December 31, 2013, in which the taxpayer is subject to the NII tax. Taxpayers also may elect to apply §1411 to a pre-§1411 effective date installment sale for a taxable year beginning on or before December 31, 2013.

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