
United States: Will your mobility costs increase as a result of the net investment income tax?

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In brief

The 'new' Net Investment Income Tax (NIIT) could have a financial impact on global mobility programs. Also known as the Unearned Income Medicare Contribution, the NIIT went into effect January 1, 2013, affecting tax years beginning on or after this date. See previous [Global Watch](#) for more details. US citizen and resident individuals with higher incomes may owe this new tax, if applicable, on passive-type income (e.g., interest, dividends, capital gains, etc.) starting with their 2013 US federal income tax returns and any applicable estimated US federal tax payments. Globally mobile individuals assigned to work in the US and abroad are potentially liable for this new tax levy.

What costs associated with the NIIT may impact your mobility program? The devil is in the details and the answer to that question is surprisingly unclear. Cross border issues layer on various complexities and multiple questions arise as to how the NIIT should be calculated. Although general guidance about how the tax is calculated is available - Section 1411 of the Internal Revenue Code (Code), which levies the NIIT, provides a core set of parameters and the Internal Revenue Service (IRS) has also issued [proposed regulations](#) and [Frequently Asked Questions \(FAQs\)](#) - but unfortunately this guidance does not provide clarity on various open questions in the international arena.

In response to this uncertainty, PwC submitted comments to the IRS ([click here](#) to view) on August 1, 2013 for consideration when final regulations are promulgated. The IRS then issued a [draft form](#) (Form 8960, *Net Investment Income Tax- Individuals, Estates, and Trusts*) the following week providing some insight as to what the IRS may have envisaged for the NIIT prior to consideration of comments.

What should mobility professionals do now while waiting for additional guidance? Take a proactive approach, review their policies, and think about how the resolution of these open issues may impact processes and budgeting for tax reimbursement and gross-up related costs. The purpose of this Global Watch is to provide a high level summary of some of the situations that may require further guidance, helping multinational employers hone in on the possible impacts.

In detail

A few core concepts

What income thresholds must be exceeded?

The NIIT applies to individuals, estates, or trusts that have modified adjusted gross income (MAGI) above defined statutory thresholds.

Thresholds range from US\$125,000 for married filing separately, US\$200,000 for single or head of household filers, and up to US\$250,000 for married filing jointly or a surviving spouse.

Does the NIIT apply to individuals that are tax resident in the US?

Yes, the NIIT applies to any US citizen or US tax resident, subject to the income thresholds noted above and assuming they have a specific type of income described below. This is the case even if he/she is otherwise exempt from US social security and Medicare under a valid totalization agreement. An important exception is that the tax does not apply to non-resident alien individuals unless a specific election is made. However, note that for an individual who qualifies as a tax resident but files a Form 1040NR because they are claiming a treaty benefit, it appears that he/she may not be considered a non-resident alien for NIIT purposes.

At what rate and on what income does the NIIT apply?

For each taxable year, the NIIT applies at a rate of 3.8% on the lesser of the 'net investment income' for such year or the excess of the MAGI for such tax year over the threshold amount.

What generally constitutes 'net investment income'?

Net investment income generally includes, but is not limited to interest, dividends, capital gains, rental and

royalty income, and non-qualified annuities. It also includes income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer.

Applying the NIIT in cross-border scenarios yields unanswered questions

PwC's comments on the proposed regulations under Section 1411 highlighted various issues where unanswered questions remain. A sample of those issues, and PwC's suggestions, are discussed below:

1. Does the NIIT result in double taxation?

A critical question is whether the NIIT may be offset by foreign tax credits for US tax purposes. If a credit is not provided, this additional tax burden could trigger increases in mobility costs, particularly where tax equalized assignees ordinarily resident abroad in a lower tax jurisdiction are now temporarily working in the United States.

For example, assume a US citizen or US resident has foreign source investment income. Assume that he/she is subject to the highest US income tax rate of 39.6% and then also pays foreign income tax of 55%. Setting aside any NIIT liabilities, he/she would generally be entitled to fully offset their US income tax liability on such income under the foreign tax credit rules, resulting in a worldwide income tax rate of 55% on such income. In effect, this person would pay a worldwide income tax rate equal to the higher of the US or foreign rate of income tax.

Beginning in the 2013 tax year, this person will also pay the NIIT at a rate of 3.8% on investment income, including income taxed overseas at 55%. The question arises whether the

NIIT paid may be offset by the foreign tax credit for US tax purposes. If it cannot, the same individual's worldwide liability on foreign source investment income would increase to 58.8% (55% plus 3.8%). This result may place US taxpayers at a comparative tax disadvantage to non-US persons with foreign investments and result in double tax to the extent of the NIIT.

IRS guidance needed

Based on a technical reading of the Code as currently written, foreign tax credits may not be used to offset the NIIT. The reasoning is that Section 27 of the Code only allows foreign tax credits against the tax imposed by 'Chapter 1' of the Code, whereas Section 1411 is included in new Chapter 2A.

Observation: *PwC believes that for many reasons, a foreign tax credit should be granted to taxpayers to offset any NIIT liabilities. Most notably, the NIIT appears to have the characteristics of an income tax as defined by US tax principles. PwC has suggested that the final regulations clarify that the NIIT may be offset by foreign tax credits in the same manner as the standard US federal income tax.*

Another related point of clarification is whether the NIIT falls or does not fall within the boundaries of the expansive network of US income tax treaties. Do current US income tax treaties, including the US Model Treaty, embrace the NIIT as a tax covered for its purposes? US treaties may be utilized to limit double taxation of US and foreign source income of individuals, e.g., through the use of reciprocal foreign tax credits. It appears that the NIIT falls within the scope of US income treaties but

a clarification in this regard would be helpful for the avoidance of doubt.

Inferences from draft Form 8960

The IRS recently released draft Form 8960, which will be used by taxpayers to calculate NIIT; no corresponding instructions were issued. This draft form infers that foreign tax credits may not be used to offset the NIIT for US tax purposes. This inference is taken from the fact that the NIIT calculated for individuals entered on the bottom of the draft Form 8960 is then carried onto Form 1040, line 60 (other taxes).

Observation: Note that the cover sheet for this draft form states that it does not reflect any public comments and no inference should be drawn from any particular line item regarding the treatment of such item in the final regulations. Nonetheless, the release of this draft form may indicate the IRS' present thinking about this issue.

2. Are retirement distributions from a foreign pension subject to the NIIT?

Foreign nationals temporarily working in the United States often participate in foreign retirement plans prior to moving to the US and receive distributions while US residents. Assume foreign national (A) participated in foreign pension plan while a non-resident alien but receives distributions while he/she qualified as a US resident alien. Typically, foreign national A will have limited or no tax-free basis in the pension resulting in the distribution being largely subject to US income tax.

Are such distributions also subject to NIIT? Distributions from certain US qualified plans are specifically excluded from the application of NIIT but no guidance has been given whether distributions from employer-

sponsored and similar foreign retirement plans are subject to NIIT. Similar questions arise when a US citizen temporarily works abroad for a foreign company and is entitled to participate in foreign retirement plans.

Observation: PwC believes that such distributions are reasonably not the type of income expected to be subject to the NIIT. Further guidance is needed from the IRS. One suggestion is for the IRS to provide safe harbors in the final regulations for foreign retirement plans, thereby preventing undue burdens on retirees receiving distributions resulting from cross-border employment.

3. How does the NIIT apply to part-year residents?

A foreign individual working temporarily in the US may only be a US resident for part of the year while being a non-resident alien for the other part of the year (e.g., a 'dual status' tax year). Neither Section 1411 nor the IRS guidance indicates how NIIT would apply in this situation. Presumably, such person would be subject to NIIT on income they generate in the part of the year they are citizens or resident aliens. And presumably, the threshold amounts apply to those who may be non-resident aliens for part of the tax year. Additional guidance in the final regulations would help clarify this scenario.

4. How should NIIT thresholds be determined when certain US elections are made?

A Section 6013(g) election treats a non-resident alien married to a US citizen or resident as a US resident for the entire taxable year. The election does not automatically require such couple to file a joint return, although it is typically made for such purpose. The proposed regulations specify that taxpayers

who make a Section 6013(g) election must make a separate election for it to apply for NIIT purposes. If this occurs, NIIT calculations include income from both spouses. And, when analyzing NIIT threshold amounts, both incomes are included and the threshold for a taxpayer filing a joint return in this scenario would be used.

But what happens if A and B make the Section 6013(g) election but do NOT make the separate election for NIIT purposes? It appears that the non-resident alien spouse would be treated as a non-resident alien for Section 1411 purposes and thus his/her portion of joint income would not be subject to the NIIT. But what threshold amount should be used?

Observation: PwC believes that, as the law is written, B may use the higher joint return threshold (US \$250,000) given that A and B in fact file a joint return. Clarification is needed on this issue to provide greater certainty for taxpayers.

5. How will the NIIT apply when an individual 'expatriates' triggering an exit tax?

Certain individuals who renounce US citizenship or who revoke green cards that were held for several years may be subject to a so-called exit tax. This event (referred to in the Code as 'expatriation' - although not to be confused with the commonly used term 'expatriate' where a person may be working overseas temporarily) can result in the individual being taxed in the US on worldwide unrealized gains and certain undistributed deferred compensation, including retirement plans.

In this situation, would NIIT apply to any deemed distributions or gains? This issue is unclear under current authorities - future IRS guidance

would help provide clarity for taxpayers.

The takeaway

The new 3.8% NIIT will likely create a number of challenges in terms of reporting and applicability to globally mobile individuals. Mobility professionals should take a proactive approach to first understand the impact of this US tax upfront and then second, consider whether any changes to either business plans or mobility policies may be appropriate. The following issues should be considered:

How would the outcome of the various scenarios above affect assignee costs?

Mobility professionals should review their policies and discuss with their advisers how this new charge may impact their tax equalization budgeting. If a company's mobility policies provide that the company will bear the cost of *any* US tax on the assignee's overall income - not just wages but also investment income, then the imposition of the NIIT could result in unexpected additional tax costs. Moreover, the issue of whether a foreign tax credit may be provided

could also become a critical cost element.

Even where there is no tax equalization, multinational companies should take steps to ensure that their internationally mobile population is aware of this tax increase on personal income which might lead to double taxation where income is also subject to tax in a foreign country.

Furthermore, it is likely that there will be situations where assignment related benefits provided by the employer may increase an individual's income over the threshold for the NIIT, resulting in an additional tax cost that the international assignee may expect to be reimbursed.

Employers who do not typically tax equalize international assignees on investment income may wish to consider how they will deal with such expectations in the context of their policies and procedures.

How will NIIT affect mobility processes?

Unlike some other US taxes, the NIIT is not withheld by the employer. However, the NIIT FAQs specify that the employee could ask the employer

to increase withholding to cover this tax. Mobility program managers may wish to communicate this option to their assignees or point out that they should consider increasing estimated tax payments to the IRS.

In addition, the NIIT should be considered when structuring overseas assignments and how assignees may file to potentially obtain a lower tax liability. The application of the NIIT makes this analysis even more complex and time-consuming as it is an additional factor to take into account.

Should changes to mobility and equalization policies occur going forward?

If the employer is currently tax equalizing executives who are on assignment to the United States for investment income, should the company reconsider this policy given the potential additional cost arising from the NIIT? If the NIIT for higher income individuals increases global mobility program costs, program managers may wish to think about modifying other benefits to offset this cost while still trying to incentivize overseas assignments.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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