

# Tax IMPACT

January/February 2024



**Are you liable for net investment income tax?**

*Learn strategies to reduce the risk*

**Spotlight on transfer pricing rules**

**Saving made easy**

*Set aside funds for your children with custodial accounts*

**Tax Tips**

# Are you liable for net investment income tax?

*Learn strategies to reduce the risk*

**D**uring the last several years, the 3.8% net investment income tax (NIIT) has ensnared a steadily increasing number of taxpayers.

Why? Because when the tax was enacted 11 years ago it applied to “high earners” — defined as single filers with modified adjusted gross income (MAGI) over \$200,000 and joint filers with MAGI over \$250,000. Those thresholds have never been adjusted for inflation. As a result, the number of taxpayers liable for NIIT has more than doubled during that time.

If you fall into the “high earner” bracket, familiarize yourself with the NIIT. The good news is there may be strategies you can use to reduce, or even eliminate, this tax.

## NIIT explained

Net investment income (NII) is gross income (less allowable expenses) from taxable interest, dividends, capital gains, rents, royalties and passive business interests. It doesn't include wages, income from a business you actively manage (except for trading financial instruments or commodities), tax-exempt interest, taxable distributions from IRAs or qualified

retirement plans, and Social Security benefits, among other things.

Also excluded from NII is the tax-exempt portion of your net gain on the sale of a principal residence (\$250,000 for single filers; \$500,000 for joint filers). But to the extent your gain exceeds the exemption amount, it's subject to NIIT.

If your MAGI (for most people, MAGI is the same as adjusted gross income) exceeds the applicable threshold, the NIIT applies to the *lesser* of 1) your NII, or 2) the amount by which your MAGI exceeds the threshold. Suppose, for example, that Mary, a single filer, typically earns MAGI of \$175,000, consisting of \$150,000 in wages and \$25,000 in interest and dividends. In 2023, she sells stock at a gain of \$75,000, so her MAGI for 2023 is \$250,000 (\$175,000 + \$75,000) and her NII for 2023 is \$100,000 (\$25,000 + \$75,000). The NIIT applies only to the \$50,000 in income above the \$200,000 MAGI threshold — for an additional tax of \$1,900 (\$50,000 × 3.8%).

What if Mary's wages were over \$200,000? In that case, the entire \$100,000 in NII would be taxable, so she'd owe \$3,800 in NIIT.

## Strategies for reducing NIIT

Tax planning strategies for reducing NIIT generally fall into two categories:

1. Strategies that reduce your NII, and
2. Strategies that reduce your MAGI.

Depending on your income level, reducing MAGI can lower your NIIT by reducing the amount by which your MAGI exceeds the threshold. For example, suppose Mark and Donna, a married



## Can a Roth IRA conversion reduce NIIT?

When you convert a traditional IRA to a Roth IRA, you're immediately subject to tax on the converted amount (to the extent that it's attributable to deductible contributions and earnings on those contributions). So, if you're contemplating such a conversion, you need to compare the current tax cost with the tax savings you'll enjoy in the future. Qualified withdrawals from Roth IRAs are tax-free, and Roth IRAs aren't subject to the required minimum distribution rules.

As you compare the relative costs and benefits, consider the potential impact of the 3.8% net investment income tax (NIIT). Although distributions from a traditional IRA aren't subject to NIIT, they do increase your modified adjusted gross income, which can trigger or increase the NIIT.

This is true for the conversion to a Roth IRA. Distributions from Roth IRAs are excluded from gross income, so they aren't subject to NIIT. Whether the Roth conversion ultimately reduces NIIT depends on factors such as whether the conversion increased the NIIT that was due at that time. It also depends on whether — and to what extent — taking a distribution from the Roth IRA allows you to reduce the NIIT that would have been owed if you'd taken the same distribution from a traditional IRA.

couple filing jointly, have MAGI of \$350,000, consisting of \$250,000 in wages and \$100,000 in NII. If they reduce their NII by \$25,000 to \$75,000, they'll save \$950 in NIIT ( $\$25,000 \times 3.8\%$ ). Reducing their MAGI by \$25,000 will have the same effect, even if their NII remains the same, because the excess of their MAGI over the threshold will drop to \$75,000.

Potential strategies for reducing NII include:

- Reducing capital gains by harvesting losses — that is, selling stocks or other securities that have declined in value — and offsetting those losses against gains,
- Reducing interest income by shifting investments into tax-exempt municipal bonds,
- Reducing dividends by shifting investments into growth stocks that pay low or no dividends, and
- Transferring income-producing investments to children or other family members in lower tax brackets.

Potential strategies for reducing MAGI include:

**Increasing tax-deductible contributions to traditional IRAs, 401(k) plans, Health Savings Accounts or similar accounts.** These are “above-the-line” deductions that reduce gross income. Below-the-line deductions — such as mortgage interest, medical expenses and charitable donations — don't affect gross income and, therefore, can't reduce NIIT.

***Often, people who aren't ordinarily subject to NIIT find themselves liable for the tax because of a significant one-time gain.***

**Making qualified charitable distributions from a traditional IRA.** If you're over 70½ and charitably inclined, you can donate up to \$100,000 per year directly from your IRA to one or more qualified

charities. These donations reduce the amount of any required minimum distributions you'd otherwise have to take, keeping those funds out of your gross income.

#### **Converting traditional IRAs into Roth IRAs.**

(See “Can a Roth IRA conversion reduce NIIT?” on page 3.) Often, people who aren't ordinarily subject to NIIT find themselves liable for the tax because of a significant one-time gain — for example, the sale of a large holding of appreciated securities. In those cases, it may be possible to reduce, or even eliminate, NIIT by spreading the sale over two or more years.

#### **Consider NIIT when making investment decisions**

The NIIT is a relatively small tax, but it can have a big impact on your investment decisions. Say you're comparing a taxable bond to a similar tax-exempt municipal bond. To be sure you're comparing apples to apples, ask your tax advisor to calculate the tax-equivalent yield — that is, the return the taxable bond must earn so that its after-tax yield is equal to the yield on the municipal bond. Whether the taxable bond is subject to the NIIT can be a significant factor. ■

## **Spotlight on transfer pricing rules**

If your business is expanding its geographical footprint beyond state or U.S. borders, it's important to understand the transfer pricing rules. In a nutshell, transfer pricing refers to cross-border pricing arrangements for transactions between related companies (including parent and subsidiary or brother-sister companies with a common parent) in different jurisdictions.

Typically, these transactions involve charges for goods, services or intellectual property (such as licensing arrangements) transferred from one company to its affiliate. Because these arrangements can be highly susceptible to manipulation to minimize a business's tax liability, taxation authorities around the world are becoming stricter in regulating them.

#### **Why it matters**

Here's an oversimplified example that illustrates the potential for manipulating transfer pricing to avoid taxation. Let's say that BroCo and SisCo are related companies with a common parent. BroCo

is based in a country with a 30% corporate income tax rate, while SisCo is based in a country with a 10% corporate income tax rate.

***Transfer pricing regulations are intended to prevent related companies from manipulating intercompany pricing to shift profits to lower-tax jurisdictions.***

BroCo manufactures component parts at a cost of \$2 million per year and sells them to SisCo for \$4 million, earning a \$2 million profit. SisCo assembles the parts into finished products, which it sells for \$6 million, also earning a \$2 million profit. BroCo's tax liability is \$600,000 (\$2 million  $\times$  30%), while SisCo's tax liability is \$200,000 (\$2 million  $\times$  10%). Therefore, the enterprise's overall tax liability is \$800,000.





Transfer pricing regulations generally require companies to use the best method based on their circumstances. Some jurisdictions require companies to furnish documentation to support their transfer prices. But even if not required, it's advisable for companies that conduct cross-border business with related companies to maintain documentation that details the methods they use to set prices. In the United States, if the IRS requests transfer pricing documentation, taxpayers have only 30 days to provide it.

Now suppose that BroCo lowers the price it charges SisCo for the component parts to \$3 million. In that scenario, BroCo's profit is reduced to \$1 million, and its tax liability is reduced to \$300,000 (\$1 million  $\times$  30%). SisCo's profit increases to \$3 million, and its tax liability increases to \$300,000 (\$3 million  $\times$  10%). Thus, the enterprise's overall tax liability drops from \$800,000 to \$600,000. The higher-tax country in which BroCo is based stands to lose significant tax revenue by this change in intercompany pricing — and might initiate a transfer pricing audit.

### How it's regulated

Transfer pricing regulations are intended to prevent related companies from manipulating intercompany pricing to shift profits to lower-tax jurisdictions. A complete discussion of these regulations is beyond the scope of this article, but generally speaking, they require the terms of intercompany transactions to be comparable to arm's-length transactions between unrelated companies.

There are several methods for setting acceptable transfer prices. For example, the comparable profits method estimates the arm's-length price by analyzing the profitability of comparable transactions involving similar companies. Another example is the cost-plus method, which determines the costs incurred by the "supplier" and applies a market-based markup to arrive at an appropriate profit.

The consequences of noncompliance can be harsh. Under U.S. law, for example, on top of back taxes and interest, companies can be hit with penalties as high as 40% of the tax underpayment (depending on the circumstances).

### What you should do

If you're concerned about transfer pricing, start by conducting a risk assessment. The higher your risk, the more important it is to invest in transfer pricing compliance.

The next step is to review and evaluate your transfer pricing policies and procedures, if any. Implement policies and procedures that are appropriate based on the nature of your business and incorporate the best methods for determining arm's-length prices. Finally, document your methodology to help support your position in the event of a transfer pricing audit.

### Not just for megacorporations

Transfer pricing is often associated with large, multinational corporations, but it can affect companies of all sizes. Transfer pricing issues can even apply to domestic companies — for example, related companies in states with different tax rates. If you're unsure of your transfer pricing obligations, consult your business and tax advisors. ■

# Saving made easy

## *Set aside funds for your children with custodial accounts*

**A**re you seeking options for helping your minor-aged child save for college or other expenses in a tax-efficient manner? A custodial account may be the answer. In a nutshell, it's a financial account for children under 18 that's opened and controlled by their parents or grandparents. Let's take a closer look at two types of custodial accounts and detail their pros and cons.

### UGMA vs. UTMA

One of the simplest ways to invest on your child's behalf is to open a custodial account under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). These accounts — available through banks, brokerage firms or mutual fund companies — are owned by the child, but managed by the parent or another adult until the child reaches the age of majority (usually 18 or 21). When the child comes of age, he or she takes over ownership and control of the account.

The biggest difference between a UGMA account and a UTMA account is that the UTMA covers more assets. For example, with a UGMA account, you can include assets such as stocks, bonds and mutual funds. With a UTMA, you can also include such assets as real estate, jewelry and art.



### Pros and cons

One of the biggest advantages of using a custodial account is its flexibility. Indeed, unlike some savings vehicles, such as Coverdell Education Savings Accounts (ESAs), anyone can contribute to a custodial account, regardless of their income level, and there are no contribution limits. Also, there are no restrictions on how the money is spent. In contrast, funds invested in ESAs and 529 plans must be spent on qualified education expenses, subject to stiff penalties on unqualified expenditures.

Contributions to custodial accounts can also save income taxes. A child's unearned income up to \$2,500 per year is usually taxed at low rates. (Income above that threshold is taxed at the parents' marginal rate.)

On the downside, other savings vehicles can offer greater tax benefits. Although custodial accounts can reduce taxes, ESAs and 529 plans allow earnings to grow on a tax-deferred basis, and withdrawals are tax-free provided they're spent on qualified education expenses. There may also be financial aid implications, as the assets in a custodial account are treated less favorably than certain other assets.

Finally, there's a loss of control involved with custodial accounts. After the child reaches the age of majority, he or she gains full control over the assets and can use them as he or she sees fit. If you wish to retain control longer, you're better off with an ESA, a 529 plan or a trust.

### Right for you?

Determining whether a custodial account is right for you requires an assessment of your financial circumstances and investment goals. Your financial advisor can help make the right call. ■

# TAX TIPS

## IRS delays Roth catch-up requirement for two years

If you're 50 or older, you can make an additional \$7,500 in "catch-up" contributions to 401(k) and similar plans. However, under SECURE 2.0, enacted in late 2022, high-earning participants (those whose wages from the plan sponsor exceed an inflation-adjusted \$145,000) can make catch-up contributions only to a Roth account starting in 2024. In other words, catch-up contributions would no longer be deductible (although qualified withdrawals would be tax-free). The IRS has delayed this requirement to 2026, allowing high-earning participants to continue making deductible catch-up contributions in 2024 and 2025. ■



## You should still file a tax return even if you're unable to pay the tax due

If you're unable to pay some or all of your taxes when they're due, you should still file a timely tax return. By doing so, you may qualify for a

reduced late payment penalty. You'll also avoid the late *filing* penalty, which is 5% per month of the balance you owe. Consider paying as much of the tax as you can when you file your return to minimize interest and penalty charges. It's a good idea to file Form 9465, "Installment Agreement Request," with your return to initiate the process of arranging a payment plan. ■

## Can you deduct online sports gambling losses? Don't bet on it

Online sports betting is now legal in most states. Unfortunately, many people who make online bets don't fully understand the tax implications of their wins and losses. In fact, winnings are taxable as ordinary income, while losses are deductible in a given year up to the amount of winnings. But here's the kicker: Gambling losses are itemized deductions. So, if you don't itemize, your winnings remain fully taxable, but you can't claim a deduction for your losses. ■



*This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2023*