Final Regulations Clarify Net Investment Income Tax

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On November 26, 2013, the IRS released final regulations under Internal Revenue Code (IRC) § 1411. The new regulations govern the laws related to the net investment income tax that was created by the *Affordable Care Act* of 2010. In addition to the final regulations, the IRS issued new proposed regulations on the computation of net investment income as it relates to the sale of interests in partnerships and S Corporations. The final and newly proposed regulations address many of the comments and concerns that were brought to the IRS regarding the original proposed regulations. In general, the final regulations retain the same foundations as the proposed regulations with certain notable modifications. Highlights of the Regulations are as follows:

Overview of the Net Investment Income Tax

The 3.8% net investment income tax (NIIT) became effective for the taxable years beginning January 1, 2013. The NIIT is imposed at the individual, trust and estate level and is paid in addition to any regular and AMT tax. For individuals the tax is imposed on the lesser of the following two amounts:

1. Net investment income, or
2. The excess of an individuals modified adjusted gross income over specific thresholds ($200,000 for single filers and $250,000 for joint)

Net investment income is defined in Regulation § 1.1411-4 and consists of the following three categories of gross income:

1. Interest, dividends, annuities, royalties, and rental income
2. Net income from a passive trade or business or a trade or business that focuses on trading financial instruments or commodities
3. Net gains from the sale of investments or non-business property or property held in a passive trade or business

Types of income excluded from the definition of net investment income include income subject to the self employment tax, income from a business in which the taxpayer materially participates, income from employment, qualified retirement and IRS distributions, and tax exempt income.

Regrouping Safeharbors

Under Regulation § 1.469-4(d)(1), a rental activity can be grouped with a non-rental trade or business activity if the rental activity and non-rental activity constitute an "economic unit" and:

1. One activity is insubstantial in relation to the other; or
2. The rental property is rented to a trade or business activity and each owner of the trade or business has the same proportionate ownership in the rental activity

Regulation § 1-1411(4)(g)(6) states that if gross rental income can be considered non-passive due to the rental activity being grouped as a trade or business activity under Regulation § 1.469-4(d)(1) then the rental income will be treated as ordinary income from a trade or business and therefore exempt from the NIIT.

For taxpayers who wish to group a rental activity with a trade or business, Regulation § 1.469-11(iv) retains the opportunity for a one time regrouping election. This election is available during the FIRST taxable year beginning after December 31, 2013, that a taxpayer is subject to the NIIT. The final regulations also address the regrouping election if a taxpayer is required to amend their tax return. Under Regulation § 1.469-11(b)(3)(C), taxpayers who were previously not subject to the NIIT may elect to regroup their activities if upon amending their returns became subject to the NIIT.

The same regulation states that a regrouping election will be void if taxpayers correctly elected to regroup on their original returns but no longer qualify for regrouping because the NIIT does not apply on their amended returns. Because the regrouping election is only available the first year a taxpayer is subject to the NIIT it is essential that a taxpayer with significant rental and nonrental activities discuss with their tax advisor the possibilities of grouping the activities together and making the regrouping election in 2013.

Qualified Real Estate Professional Safe Harbor

IRC § 469 leaves very few opportunities for a taxpayer to have non-passive rental income. Specifically, rental income is always considered passive except in the following instances:

1. Income earned by a real estate professional who materially participates in the rental activity,
2. Rentals "grouped" with a trade or business in which the taxpayer materially participates (discussed above),
3. Passive income re-characterizations (to be discussed later) and
4. Certain other rental income detailed in 1.469-1T(e)(3)(ii).

Because the NII rules generally follow the 469 passive activity rules, unless one of the exceptions listed above can be met, any rental income will be considered passive and subject to the NIIT.

The qualified real estate professional safe harbor was one of the main areas of confusion when the original proposed regulations were released. The confusion stemmed from the fact that the proposed regulations did not clearly state whether a real estate professional's rental income would be considered net investment income. In order to meet this safe harbor a taxpayer must (1) be considered a qualified real estate professional and (2) materially participates in rental activities.

For a taxpayer to be considered a qualified real estate professional they must meet the requirements of IRC § 469(c)(7)(B). This section states that a real estate professional is:

1. A taxpayer who performs more than one-half of their trade or business personal services in a real property trade or business in which the taxpayer materially participates and

2. Such taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

The proposed regulations created many concerns in the tax and real estate worlds because the regulations were not clear as to whether the rental income earned by qualified real estate professional who materially participates in rental activities would be included as net investment income. The final regulations, however, respond to these concerns in Regulation § 1.1411-4(g)(7). This section states that if a real estate professional participates in one or more rental activities for more than 500 hours during the year, or has participated in rental activities for more than 500 hours during any five of the preceding ten years, then the rental activity is deemed to be derived in the ordinary course of a trade or business and not subject to the NIIT.

It should be noted that unless the taxpayer has grouped their rental activities together under Regulation § 1.469-9(g) then the 500 hour test will be applied to each individual rental property making it significantly harder for a taxpayer to meet the requirement. Therefore it would be wise for a taxpayer who maintains several rental properties to discuss with their tax advisor the possibility of making the grouping election.

Recharacterization of Passive Income to Nonpassive

Regulation §1.1411-5(b)(2) provides clarification regarding the interaction between the net income recharacterization rules of IRC § 469 and

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1411. For purposes of IRC § 1411, the final regulations generally follow the IRC § 469 characterization of income and gains. Specifically, Regulation § 1.1411-5(b)(2) states that income or gain from a trade or business that has been recharacterized under certain sections of IRC 469 as "not from a passive activity" will not be subject to the NIIT.

One important example of this recharacterization is with self-rental income. Under Regulation § 1.469-2(f)(6), rental income received by a taxpayer will be recharacterized and will not be considered passive if the property is rented for use in a trade or business in which the taxpayer materially participates (self-rental income). However the proposed regulations contradicted the regulations under IRC § 469 and stated that any self-rental income would still be considered passive for NIIT purposes. The final regulations clarified these inconsistencies stating under Reg. 1.1411-4(g)(6) that Regulation § 1.469-2(f)(6) will be followed for NIIT purposes and that rental income will be considered ordinary income from a trade or business if the property is rented to a trade or business in which the taxpayer materially participates.

Self-Charged Interest

The final regulations also address the problem of self-charged interest income. Under the proposed regulations, if a taxpayer loaned money to a passthrough entity, in which he was an active participant, any interest income related to that loan (ie. self-charged interest income) would be considered net investment income. At the same time, any allocable share of interest expense passed through from the business entity would not be considered a deduction for NIIT purposes because the expense was generated from a nonpassive activity. To prevent this mismatch of income and expense Regulation § 1.1411-4(g)(5) provides a special rule to address self-charged interest.

The regulation states that in the case of self-charged interest income received from a nonpassive entity, the amount of interest income excluded from the NIIT will be equal to the taxpayer's allocable share of nonpassive deductions. One item for a taxpayer to considered while planning for their taxes is to ensure that any self-charged interest income is only reduced by their share of allocated interest expense because any portion of the self-charged interest income that remains is still subject to the NIIT.

Gains from the Sale of S Corporation Stock or Partnership Interests

Under the proposed regulations the sale of stock in an S Corporation or the sale of partnership interest would result in a certain portion of the gain being included as net investment income. Proposed Regulation § 1.1411-7, stated that the amount of the gain subject to the NIIT was determined by reducing the gain on the sale by the portion of the gain allocable to the assets of the trade or business. This resulted in the taxpayer having to go through a timely and sometimes costly process to determine the value of the assets of the trade or business and to calculate the portion of the gain resulting from the sale of these assets. For a shareholder or partner holding only a small interest in the passthrough entity, going through this process would most likely be time consuming and not cost effective.

In response to these shortcomings, the IRS withdrew the original proposed regulations and issued more logical and direct regulations under Prop. Regulation § 1.1411-7.

The newly proposed regulations provide that the amount of gain included as net investment income is the lesser of:

1. A taxpayers recognized gain on the sale of their interests, or
2. The taxpayers allocable share of net gain from a deemed sale of an entity's assets which would be subject to the NIIT.

In addition to the changes noted above, the new proposed regulations provide a potential shortcut in Prop. Regulation § 1.1411-7(c). This section states that if a seller of interests in an S Corporation or partnership qualifies then the optional simplified reporting method can be

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used to determine the amount of gain to include as net investment income. The simplified reporting method determines the gain or loss subject to the NIIT by multiplying the taxpayer's gain on the sale of interest by a fraction made up of the taxpayers net investment income including deductions from the past three years, and the sum of all items (income, gains, losses and deductions) allocated to the taxpayers during the same three year period. It should be noted that the simplified reporting methods will only be beneficial when the amount of gain associated is expected to be small. Because the proposed regulations state multiple ways to calculate the gain subject to the NIIT it is essential that any taxpayers planning on selling their interest in an S Corporation or partnership to consult with their tax advisor to determine the most practical approach to calculate the amount of income subject to the NIIT.

The final § 1411 regulations did make significant progress in clarifying the law on net investment income, however, this law still remains complex and could significantly impact a taxpayer's future tax liability. Although this article highlights many of the significant changes between the final and proposed regulations it would be prudent to consult your tax advisor to help interpret the new tax laws and apply them to your business and individual situations.

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