STRUCTURING BUSINESS OWNERSHIP, OPERATION AND SALE TO MITIGATE THE 3.8% OBAMACARE TAX, SECA TAX AND FICA TAX

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I. INTRODUCTION AND EFFECTIVE DATES.

The purpose of this article is to provide information helpful to planning for minimization of taxes. It does not explain the methods of computation of the amount of tax liability. It also does not discuss changes from the old proposed regulations to the new final and proposed regulations of the so-called Obamacare Tax. The new tax is also referred to as the "Medicare Tax," the "Net Investment Income Tax" or "NIIT."

The NIIT is a new additional tax on individuals, estates and trusts effective for tax years beginning on and after January 1, 2013 of 3.8% on Net Investment Income ("NII") to the extent Modified Adjusted Gross Income exceeds certain thresholds ($250,000 if married, $200,000 if single, and, in 2015, $12,300 for trusts and estates). On November 26, 2013, Final Regulations (TD 9644, referred to herein as "Final Regulations," "NIIT Regulations," or "Regulations") and Proposed Regulations (26 CFR Part 1, REG-130843-13, referred to herein as the "Proposed Regulations") were promulgated. These replace previous Proposed Regulations published December 5, 1012 (26 CFR Part 1, REG 130507-11, 77 Fed. Reg. 72611). Code Section 1411 references Code Section 469 for purposes of determining whether a trade or business is a passive activity, and therefore subject to NIIT. References herein to the regulations issued under Code Section 469 (the passive activity loss rules) are sometime referred to as the "PAL Regulations."

Effective dates of the Final Regulations are generally January 1, 2014, but many of the Regulation Sections permit a taxpayer to elect to apply them in 2013:

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"Applicability Dates: For dates of applicability, see §§1.469-11(b)(3)(iv)(D); 1.1411-1(g); 1.1411-2(e); 1.1411-3(f); 1.1411-4(i); 1.1411-5(d); 1.1411-6(c); 1.1411-8(c); 1.1411-9(d); and 1.1411-10(i)." (Page 1 of the Final Regulations)

Example: Reg. Sections 1.1411-1(f) and (g):

(f) Application to taxable years beginning before January 1, 2014--(1) Retroactive application of regulations. Taxpayers that are subject to section 1411, and any other taxpayer to which these regulations may apply (such as partnerships and S corporations), may apply §§1.1411-1 through 1.1411-10 (including the ability to make any election(s) contained therein) in any taxable year that begins after December 31, 2012, but before January 1, 2014, for which the period of limitation under section 6501 has not expired.
(2) Reliance and transitional rules. For taxable years beginning before January 1, 2014, the Internal Revenue Service will not challenge a taxpayer's computation of tax under section 1411 if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 1411. For example, a taxpayer's compliance with the provisions of the proposed and final regulations under section 1411 (REG-130507-11 or REG-130843-13), generally, will be considered a reasonable, good faith effort to comply with the requirements of section 1411 if reliance on such regulation projects under section 1411 are applied in their entirety, and the taxpayer makes reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted by the positions taken in taxable years beginning after December 31, 2012, but before January 1, 2014. A similar rule applies to any other taxpayer to which these regulations may apply (such as partnerships and S corporations).

(g) Effective/applicability date. This section applies to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with paragraph (f) of this section.

Effective dates of Proposed Regulations are generally January 1, 2014, but the taxpayer generally can elect to apply them in 2013:

"To coordinate these proposed regulations with the 2013 Final Regulations, the proposed regulations are proposed to have the same effective date as the 2013 Final Regulations. **However, any provisions adopted when these proposed regulations are finalized that are more restrictive than these proposed regulations would apply prospectively only. Taxpayers may rely on these proposed regulations for purposes of compliance with section 1411 until the issuance of these regulations as final regulations**. See §1.1411-1(f)[of the Final

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Regulations]." (Part 1. Overview of Proposed Regulations in *Explanation of Provisions*, of the Proposed Regulations).

"These regulations are proposed to apply for taxable years beginning after December 31, 2013, except that §1.1411-3(d)(3) [charitable remainder trust (CRT) election for simplified method] is proposed to apply to taxable years beginning after December 31, 2012." (*Proposed Applicability Date,* of the Proposed Regulations).

See also Prop. Reg. Section 1.1411-3(f)[for applicability date for CRTs]; Prop. Reg. Section 1.1411-7(h)[for applicability date of dispositions of certain active interests in partnerships and S corporations].

First things first: The CPAs for client need to be consulted and involved when this is brought up with the client. Having the lawyers and the CPAs both engaged will get things moved along much more expeditiously. Some have a good grasp of the NIIT, some have little understanding. Some understand the planning ideas and have been working through the new tax regime. Most have more understanding of SECA and FICA. We all want to understand more.

Secondly, in many instances, basic planning effective to avoid the NIIT will cause the SECA or FICA Tax to replace it. They are effectively the same tax rate, except that 1.45% of those 3.8% taxes is deductible, reducing the net tax rate to about 3.2%, assuming a 40% marginal income tax rate. Also trading the Obamacare Tax for the SECA Tax may create greater tax liability if the taxpayer has earned income less than the so-called FICA limit, which is $117,000 for 2014. **There is one important advantage to avoiding the NIIT, even if SECA might apply: upon the sale of the business, SECA may well be avoided in any event, but the NIIT would apply to a seller upon sale of the business unless the material participation test or the significant participation passive activity test (discussed below) was met by the particular seller during its final years to avoid the NIIT.** An after-tax 3.8% of a lot is still a lot.

Thirdly, this discussion of SECA and FICA generally ignores the OASDI portion of the tax (the 12.4% portion), which applies only to the first $117,000 of taxable wages or self-employment income in 2014.

The NIIT is a standalone independent income tax with no itemized deductions. Properly allocable deductions against NII are allowed, which the Regulations provide may be taken into account. Code Section 1411(c)(1)(B); Reg. Section 1.1411-4(f). The NIIT has no loss carryforward, except the Section 1411 NOL Amount derived from the Section 172 net operating loss is deductible. Reg. Section 1.1411-4(f)(2)(iv); Reg. Section 1.1411-4(h). **So irregular income that produces negative NII every other year may result in a greater tax liability than a level positive NII totaling the same amount over a period of years.** Even irregular income from an activity producing passive activity loss (PAL) intermittently with passive gains over the years may avoid higher NIIT if subsequent NII will free up previously suspended losses from the activity. See examples at Reg. Section 1.1411-4(f)(2)(v). Also the Proposed Regulations

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consider the application of capital loss carryforwards derived from Code Section 1212(b)(1). Prop. Reg. Section 1.1411-4(d)(4)(iii).

There is much greater detail than what is discussed in this article, but it is the author's attempt to organize an approach to planning and provide citations to the authority for the statements made. Many areas are unsettled or have little or no authority. One way to look at planning for the increased tax liability under Code Section 1411 is that there are three variables that must be considered: THE PARTICULAR ECONOMIC ACTIVITY, THE BUSINESS FORM, AND TAXPAYER STATUS.

II. OVERVIEW OF THE LAW.

There are 3 mutually exclusive taxes that are effectively 3.8%.

These taxes are in addition to the regular income tax. On its face one it first appears that one of them will apply to add an additional tax on income of 3.8%. But that is not always true. They are the FICA and SECA tax and the NIIT. Together they are referred to in this outline as the **3.8% Taxes**. FICA and SECA apply to individuals and the NIIT to individuals and trusts and estates. None of these taxes apply to C Corporations. The NIIT might literally apply to UBTI of exempt organizations that are trusts, but not to UBTI of exempt organizations that are corporations. If the taxable income is not from or attributed to a TorB or rental real estate activity, then it will be subject to NIIT, if over the MAGI threshold described below, unless it is other special income, such as income subject to SECA or FICA, income exempt or excluded from regular income taxation, or retirement distributions.

The goal is to avoid all the 3.8% Taxes.

The goal cannot always be attained, and if not fully attained, it might be achieved in part. There are methods that can be employed to get around all such taxes in certain situations. The methods differ depending on the activity and structure of the businesses and activities. The avoidance may extend to also avoiding the 3.8% Taxes on sale of the business or rental real estate property, whether or not avoided on business activity, which could otherwise be subject to these taxes. **So, there could be a sale or liquidation of the activity that will avoid the 3.8% Taxes even if the activity itself is subject to the SECA or FICA tax.** Prop. Reg. Section 1.1411-7. So planning to avoid the NIIT in anticipation of a sale of the business is a significant issue. Avoiding a 3.8% tax on a $10,000,000 capital gain saves an after-tax $380,000, which is the equivalent of earning $760,000 of taxable income, assuming a 50% marginal income tax rate.

FICA and SECA.

FICA is social security tax on employee compensation and SECA is the self-employment tax for sole proprietors and partners in partnerships in a trade or business. The taxes aggregate 15.3% up to $117,000 of FICA and SECA income in 2014 (the so-called FICA limit), and 2.9% thereafter. The 2.9% portion is the hospital insurance tax (the HI tax) that does not have any ceiling on applicability (for W-2 employees, 1.45% is borne by each of the employer and the employee). The balance is the OASDI 12.4%

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portion imposed up to the FICA limit (for W-2 employees, 6.2% is borne by each of the employer and the employee).

NIIT.

The Patient Protection and Affordable Care Act (a/k/a Obamacare, PPACA, or ACA), which includes the NIIT, did not change the FICA or SECA tax rules, EXCEPT there is an additional tax of 0.9% added to the 2.9% HI tax (which may apply even if compensation is less than the FICA limit if MAGI described below is high enough) if Modified Adjusted Gross Income (MAGI) exceeds $200,000 for a single individual or $250,000 for married couples or $12,150 (in 2014) for trusts and estates. MAGI is generally Adjusted Gross Income (AGI) less net excluded foreign income, so for most AGI is the relevant variable. None of the 0.9% is deductible in determining regular taxable income or AMTI.

The 3.8% NIIT applies to NII for the taxable year, but limited to the extent MAGI exceeds the applicable $12,150, $200,000 or $250,000 limit. NII generally excludes exempt income and also excludes retirement income, such as distributions from Qualified Plans and IRAs. Code Section 1411(c)(5); Reg. Section 1.1411-8. NII generally includes interest, dividends, annuities, royalties, rents, and net gains, other than such income which is derived in the ordinary course of a **trade or business (referred to herein as "TorB")**, plus net income or less net loss from passive activities for a taxable year (trades or businesses in which the taxpayer does **not materially participate** for such taxable year). Code Section 1411(c)(1); Reg. Section 1.1411-5(b)(1); Reg. Section 1.469-T(e)(1)(i). Material participation, therefore, is of utmost importance in most NIIT analysis. Material participation is described in **Part III** below (on p.6). One owner of a partnership, LLC or S Corporation may have NIIT, while another who materially participates in the business may not.

The NIIT also includes capital gain, including capital gain upon sale of the business. Installment sale gain recognition on sale might avoid the NIIT by keeping the MAGI below the threshold by spreading the taxable gain over more taxable years. If the NIIT does not apply in year of sale, then installment sale gain (but not the interest on deferred payments) will also avoid the NIIT, even if paid years after the sale. The NIIT will not apply if SECA applies to the particular income item. Code Section 1411(c)(6); Reg. Section 1.1411-9. The NIIT will not apply on income derived from a TorB in which the taxpayer materially participates**,** except for income from the TorB of trading in financial instruments or commodities described in Code Section 475(e)(2), and except for real estate rental activity unless the taxpayer is a real estate professional. Code Section 1411(c)(2)(B); Reg. Section 1.1411-4(a)(1)(ii); Reg. Section 1.1411-5(a)(2). Gain on the sale or liquidation of stock or ownership interests in a TorB sale or liquidation of its assets avoids the NIIT if income from the TorB would avoid the NIIT. Code Section 1411(c)(4); Prop. Reg. Section 1.1411-7(a). Any earnings, such as interest, on working capital held in a TorB will be NII. Code Section 1411(c)(3); Code Section 469(e)(1)(B); Reg. Section 1.1411-6(a), which refers to Reg. Section 1.469-2T(c)(3)(ii).

Code Section 1411 and the Regulations and the Proposed Regulations promulgated thereunder do not affect taxation for any other purpose. Reg. Section 1.1411-1(c); Temp. Reg. 1.469-1T(d)(1).

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Assumption: for simplicity of discussion it is assumed that the taxpayer has MAGI in excess of the applicable thresholds and would be subject to the NIIT, and that the taxpayer has earned income above the FICA/SECA limit.

For purposes of this outline the term "TorB entity" means an entity that is a tax partnership (a partnership, limited partnership (LP) or limited liability company (LLC)) or an S Corporation, and which is involved in a trade or business activity, and which may be rental real estate activity. It does not include C corporations, except for Code Section 469 C Corporations [closely held corporations and personal service corporations – discussed below].

A general overview of other considerations.

(i) The 26% - 28% Alternative Minimum Tax may apply on Alternative Minimum Taxable Income ("AMTI"). So there might be tension when planning for reduction in one affects the other.

(ii) Trusts reach the maximum income tax bracket of 39.6% at $11,950 in 2013 and $12,150 in 2014, as well as the 3.8% NIIT threshold. As a consequence, the federal maximum rate on ordinary income is 8.4% greater than 2012 (8.8% greater on capital gains). Distributions to beneficiaries generally reduce taxable income of trusts and estates, and transfer the taxable income to the beneficiaries to the extent of the entity's distributable net income (DNI). Trusts and estates can elect to treat distributions made up to 65 days after the tax year as being made in the prior year (by March 6, 2015 as being made in 2014). Code Section 663(b). Beneficiaries might be in much lower brackets and not be anywhere near having a $200,000 or $250,000 MAGI. Much savings may be possible if distributions are made to beneficiaries running through the lower brackets.

(iii) The NIIT may not apply if the taxpayer materially participates or significantly participates or is deemed to materially participate in a TorB or if income is subject to SECA.

(iv) The grouping of activities under the PAL rules had previously focused solely on recognizing deductions from otherwise nondeductible passive activity losses (PALs - losses from a TorB in which the taxpayer does not materially participate) that could not offset passive income generators (PIGs - income from TorB activities in which the taxpayer does not materially participate). Grouping was primarily intended to cause the taxpayer to satisfy the material participation test for all grouped activities to permit losses from grouped activities to avoid the passive activity loss limitations of Code Section 469. Now grouping considerations include avoidance or mitigation of the NIIT under Code Section 1411. It is possible, but in the author's view unlikely, that grouping benefitting the taxpayer under either PAL limitations or NIIT will be detrimental for the other. See the Example on p.8.

(v) If the MAGI of a taxpayer as safely under the NIIT threshold, then NIIT may not be a concern, and designing payments as NII and not subject to SECA tax may reduce tax liability. If the taxpayer is below NIIT threshold, and especially of she is below the FICA limit, guaranteed payments for capital may be the best structure. The characterization of payments as for capital or services may be subject to the

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reasonableness of the amounts. Reg. Sections 1.707-3 and 1.707-4. III. MATERIAL PARTICIPATION (NECESSARY TO AVOID THE 3.8% TAXES) EXPLAINED.

(vi) The PAL loss limitation rules under Code Section 469 must be considered. If a PAL loss is disallowed, it is suspended and allocable to the activity the generated the loss. The suspended losses are deducted in subsequent years when the activity is not subject to the PAL loss limitation rules, whether because it is sold or because it is not a passive activity. Reg. Sec. 1.469-1(f)(4)(i); Reg. Sec 1.469-1T(f)(4).

Important definition for this discussion: Material Participation. As stated above, to avoid the NIIT, a taxpayer must materially participate in a TorB (BUT – that is still not enough if the activity is rental real estate to nonaffiliates UNLESS the taxpayer is also a Real Estate Professional – discussed below) .

A taxpayer <u>materially participates</u> in an activity in a taxable year if:

(1) The individual participates in the activity for more than 500 hours during such year.

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (participates for more than 100 hours but no more than 500 hours in a TorB activity (Reg. Section 1.469-5T(c)) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (<u>the fields of health, law, engineering, architecture, accounting, actuarial science or consulting</u>, referred in this discussion as "**Professional Services**"), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; <u>or</u>

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

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Reg. Section 1.469-5T(a) and (d); *Mordkin v. Comm'r*, T.C. Memo 1996-187 (reasonableness of the above regulation confirmed). Source: Code Section 469(h)(1)["A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is (A) regular, (B) continuous, and (C) substantial."]. "[A]ny work done by an individual (without regard to the capacity in which the individual does the work) in connection **with an activity in which the individual owns an interest at the time the work is done** shall be treated as **participation** of the individual in the activity." Reg. Section 1.469-5(f)(1). See also Reg. Section 1.469-5(h)(3)(prior year material participation as an owner of a passthrough entity will constitute material participation in the current year for the material participation tests (5) and (6), which take into account prior years activities). Such clearly covers work of a shareholder/employee of an S Corporation that is a general partner of a limited partnership carrying on the applicable activity. One cannot materially participate in an activity if not an owner. See Reg. Section 1.469-5T(k) Ex.(6).

Work done by an individual as an investor in an activity is not participation unless the taxpayer "is directly involved in the day-to-day management or operations of the activity." Nonqualifying investor work of a taxpayer includes reviewing financial statements, preparing summaries for himself, and "monitoring the finances or operations of the activity in a non-managerial capacity." Reg. Section 1.469-5T(f)(2)(ii); see also *Tolin v. Comm'r*, TC Memo 2014-65 (lawyer was not merely investor in racehorse activity and losses allowed). Satisfying the participation or other standards of other Code Sections is not taken into account in determining whether the taxpayer materially participates under Code Section 469 and, therefore, under Code Section 1411. Reg. Section 1.469-5T(b)(2)(i).

Section 469 C Corporations. Closely Held C Corporations and Personal Service Corporations for which PAL rules apply[1] are described in Section 469(j)(1) and (2). Together they are sometimes referred to as Section 469 C Corporations. A Closely Held C Corporation is described in Section 469(j)(1), referring to Section 465(a)(1)(B), referring to Section 542(a)(2)[generally a corporation more than 50% owned by 5 fewer individuals]. A Personal Service Corporation is described in Section 469(j)(2), referring to Section 269A(b)(1))[a corporation which principal activity is performing personal services that are substantially performed by employee/owners]. They are the only taxpayers other than individuals, estates or trusts that are subject to PAL rules. They are deemed to materially participate if holders of more than 50% in value of the corporation each materially participate in the corporation's business activity.[2] Such holders are not required to have voting control in order for such individuals' work to satisfy the material participation test.

Grouping of activities may be very important if multiple brother-sister entities or activities are involved. "One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Code Section 469."[3] If there are too many ungrouped activities that could be grouped, then there is an issue of whether neither the 500 hour test of paragraph (1) nor the "significant participation"

[1] The NIIT rules do not apply. Code Section 1411(a).
[2] Code Section 469(h)(4); Reg. Sec. 1.469-1T(g)(3).
[3] Reg. Section 1.469-4(c).

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test of paragraph (4) above will be satisfied if grouping is not carefully made. Grouping may consider participation in activities of Section 469 C Corporations, which are discussed below. However, what is a good for mitigating Code Section 1411 may be bad for purposes of Code Section 469, as shown in the following example. Grouping does affect whether one is a real estate professional as defined in Code Section 469(c)(7)(B) by potentially causing grouped activities to satisfy the material participation test to test under the one-half of time test and the 750 hour test.

Example:

> *Example 1:* Assume a Tom has $500,000 in taxable income for the taxable year, and is the sole owner of S Corporation businesses 1, 2, and 3, engaged in TorB Activities 1, 2, and 3 respectively. Tom participates 90 hours in TorB Activity 1, 90 hours in TorB Activity 2, and 500 hours in TorB Activity 3, which is the same kind of TorB as Activity 2, but a different business. Tom had received and reported separately reasonable compensation from each of them. If Tom does not group Activity 2 with Activity 3, then the material participation test of Temp. Regs. 1.469-5T(a) is satisfied with respect to Activity 3 only. Activities 1 and 2 are passive, and the net income from those activities is NII.[4] If Tom groups Activity 2 with Activity 3 then the material participation test is satisfied for Activities 2 and 3, and there is no NII with respect to the net income from those activities.
>
> Assume further that Tom had $100,000 of taxable loss from Activity 1, $200,000 taxable income from Activity 2, and $200,000 of taxable loss from Activity 3, in addition to his compensation from each. If the activities are not grouped, then $3,800 of NIIT arises from the $100,000 net passive activity income of Activities 1 and 2. Activity 3 is not passive so its $200,000 loss is not limited. If Activities 2 and 3 are grouped, then Tom materially participates in grouped Activity 2+3, and its income is not NII, and NIIT is reduced by $3,800. However, Activity 1 is the only passive activity, and its $100,000 loss is suspended resulting in an increased regular income tax liability of $39,600. If Tom had worked 10 more hours in Activity 2, then the activity would be a significant participation passive activity and the anti-PIG rule of Temp. Regs. 1.469-2T(f)(2) would have caused its income to be treated as nonpassive and not subject to NIIT, although the loss of Activity 1 would be suspended.

A limited partner interest cannot achieve material participation to avoid the NIIT by only satisfying the paragraph (4) "significant participation" test but not the paragraphs (1), (5), or (6) tests. A limited partner can materially participate only if he satisfies paragraphs (1), (5), or (6) above or is also a general partner.[5] Work done by a limited partner as an employee of a general partner in the activity of the limited partnership, whether or not an owner of the general partner, is counted to determine

[4] Significant participation passive activity recharacterization (one of the so-called anti-PIG rules) is discussed below, and does not apply under the facts of this example.

[5] Reg. Section 1.469-5T(e)(2).

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material participation.[6] However, a limited partner who significantly participates may avoid the NIIT as being a "significant participation passive activity" described below. See Anti-PIG Rules discussion below.

A spouse's activity is imputed. Reg. Section 1.469-5T(f)(3); Code Section 469(h)(3) and (5).

A taxpayer cannot contrive material participation. Work will not be treated as participation in an activity if both: (i) it is not customarily done by an owner of the activity and (ii) one of the principal purposes of such work is to avoid passive activity characterization.[7]

A shareholder of a C Corporation (other than a Section 469 C Corporation) cannot avoid NIIT on interest income from a loan to the corporation. Reg. Section 1.1411-4(g)(5); Reg. Section 1.469-7(a) and (b)(1).

The grantor of a grantor trust is the taxpayer for purposes of NIIT and PAL regimes. Reg. Section 1.1411-3(b)(1)(v); S. Rept. No. 99-313, at 735 (1986), 1986-3 C.B. (Vol. 3) 1, 735, fn 21.

Section 469 C Corporations and Self-Charged Rent. A shareholder/employee of a Closely Held C Corporation or a shareholder/employee in a Personal Service Corporation **can** avoid NIIT on rentals of real estate and other tangible property to such corporation if the taxpayer materially participates in the TorB of the corporation. The applicable NIIT Regulation Section 1.1411-4(g)(6) does not expressly so provide. However, Reg. Section 1.469-2(f)(6) refers to Reg. Section 1.469-2(e)(2) for describing the TorB for which material participation may be satisfied, although Reg. Section 1.469-2(e)(2) does not address this matter. Reg. Section 1.469-4(a) defines activities of a taxpayer to include those conducted through such corporations, because they are subject to Code Section 469.[8] Reg. Section 1.469-4(a) provides:

> This section sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. *A taxpayer's activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships.* [emphasis added]

The Tax Court, in *Schwalbach v. Comr*, 111 TC 215 (1998), held that the definition of a shareholder's activity in Reg. Section 1.469-4(a) applies to Reg. Section 1.469-2(f)(6)[self-charged rent].[9] Does the activity also have to be that of a shareholder? To what extent, if any, can the NIIT Regulations vary from the PAL regulations concerning material participation? These and other asked and yet to be asked questions await definitive answers.

Section 469 C Corporations and Self-Charged Interest. The same reasoning by which the Tax Court in *Schwalbach* held the the activities of the shareholder applied for purposes of self-charged rent

[6] Reg. Section 1.469-5T(k) Ex.(2).
[7] Reg. Section 1.469-5T(f)(2)(i); Reg. Section 1.469-5T(k) Ex.(7)(ii).
[8] Code Section 469(a)(2).
[9] 111 T.C. at 219. In accord, *Williams v. Comr*, TC Memo 2015-76; *Carlos v. Comr*, 123 T.C. 275 (2004).

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from a Section 469 C Corporation to its shareholder may also apply to treat interest income from such corporation as as interest income would be treated if it were from an S Corporation to its shareholder. Reg. Section 1.1411-4(g)(5)[self-charged interest] refers to "interest … received by the taxpayer from a nonpassive activity of such taxpayer." On the other hand, it may be only by grace of the government through issuance of PAL Regulation Section 1.469-7(a) that the self-charged interest rule arises. That provision is not temporary and remains effective. The regulation provided only for interest charged to a passthrough entity in which the taxpayer holds an interest, which is defined to be only a partnership or an S Corporation. It may or may not follow that a shareholder of a Section 469 C Corporation who materially participates in the activity of the corporation can avoid NIIT on interest from loans to the corporation as provided in Reg. Section 1.1411-4(g)(5). The specific computation of the amount of interest so treated is discussed in **Paragraph IV.A.4** below.

Regular C Corporations and Self-Charged Rent. There is little guidance as to whether a shareholder/employee of a regular C Corporation (a C Corporation that is not a Section 469 C Corporation) can satisfy the material participation requirement to cause self-charged rental income to avoid the NIIT. Temp. Reg 1.469-1T(g) does expressly provide that Section 469 does not apply to corporation other than Section 469 C Corporation, but makes no mention of whether the section may apply to its shareholders. For purposes of Section 469, is not necessary that regulations permit a C Corporation shareholder to be able to meet the material participation requirement. "We find nothing in the statutory text, or in its legislative history, that conditions the effectiveness of section 469 on the issuance of regulations. *See Trans City Life Ins. Co. v. Commissioner*, 106 T.C. at 299-300; *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996); *H Enters. Intl., Inc. v. Commissioner*, 105 T.C. 71, 81-85 (1995)." *Schwalbach,* 111 TC at 226. Code Section 1411 incorporates Code Section 469, so there could be material participation in circumstances not covered by regulation. There was a temporary regulation that specifically provided that the participation of a shareholder of a regular C Corporation's activities is not taken into account to determine if the shareholder materially participates in the activity. Reg. Section 1.469-4T(b)(2)(ii)(B) and its example. However, that temporary regulation expired after the IRS withdrew the companion proposed regulations. 57 Fed. Reg. 20803; Code Section 7805(c)(2); Reg. Section 1.469-11(a)(2); *Schwalbach*, 111 T.C. at 224.

Anti-PIG Rules. The PAL regulations carved out net income from certain otherwise passive activities that tended to generate positive taxable income to be recharacterization as not being passive activities. A passive activity that results in positive taxable income is sometimes referred to as a "passive income generator" or a "PIG." The rules that recharacterize PIGs are enumerated in Reg. Section 1.469-2T(f). The rules are affectionately called the anti-PIG rules. One is the self-charged rental activity rule under Reg. Section 1.469-2(f)(6)[see Part IV.A.2 ("Real Estate and other Rental Activity to Affiliates") on page 15], which applies for NIIT purposes.[10] Another is the self-charged interest rules under Reg. Section 1.469-7(c)[See Part IV.A.2 ("Loans to Affiliates") on page 16], which also applies for NIIT

[10] Reg. Section 1.1411-4(g)(6).

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purposes.[11] Yet another anti-PIG rule is the significant participation passive activity recharacterization rule, discussed immediately below.

Significant Participation Passive Activity.[12] Even if a TorB activity of a taxpayer does not rise to the level of material participation described above, its net income may still be recharacterized as other than from a passive activity and avoid NIIT (except for rental activity, since the statutory test to avoid deemed passive activity status requires material participation, and that is limited to rental real estate activity).[13] If all "significant participation passive activit[ies]" of a taxpayer in a year together result in net income, then a prorata portion of the net income from each significant participation passive activity ("SPPA") that generates net income (allocated on the basis of their respective net incomes) is treated as being not from a passive activity, and hence not NII.[14] However, if the total of all SPPAs' aggregate income in a taxable year is a net loss, then such remain as being from passive activities and, if not suspended PAL losses, reduce other NII. An SPPA is TorB activity, other than rental activity,[15] in which the taxpayer participates for more than 100 hours but not more than 500 hours, but which is not treated as material participation.[16] The SPPA recharacterization rule should apply to income from limited partner interests.[17]

SPPA Recharacterization does not Extend to PAL Credits, 5 out of 10 year rule, or self-rental activity. Even though the SPPA rule will cause otherwise passive activity income from an activity to avoid the NIIT, such income will not offset PAL losses and passive activity credits arising from the same activity remain suspended.[18] To utilize the credits, the taxpayer must either (i) materially participate in

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[11] Reg. Section 1.1411-4(g)(5).

[12] The author thanks ACTEC Fellow Richard L. Dees, Esq. and Jeffrey K. Ekeberg, Esq. for their time in analyzing this issue.

[13] Reg. Section 1.1411-5(b)(1)(ii) and (2); Reg. Section 1.469-2(f)(10); Reg. Section 1.469-2(f)(3), (4), and (7); Section 469(c)(7)(B).

[14] Reg. Section 1.469-2T(f)(2).

[15] Reg. Section 1.469-9(e)(1); Code Section 469(c)(2) and (7). *See also* Reg. Section 1.469-2T(f)(2)(ii), which references Reg. Section 1.469-1T(e)(2), which references Reg. Section 1.469-1(e)(2), which references Reg. Section 1.469-4(b)(1)[which excludes rental activity, which is defined in Reg. Section 1.469-4(b)(2), which references Reg. Section 1.469-1T(e)(3)]. Whew!

[16] Reg. Section 1.469-5T(c); Reg. Section 1.469-2T(f)(2).

[17] Reg. Section 1.469-5T(e)(2)(the exception for limited partner interests literally applies only for purposes of material participation and not for significant participation).

[18] Code Section 469(d)(2); Reg. Section 1.469-3T. Generally passive activity credits ("PAL credits") are credits described in Code Sections 30 through 30D and 38 through 45R that arise from passive activity. The author became aware of this anomaly from writings of Steven B. Gorin, Esq. in 2015. As Gorin points out, this "whipsaw" works only for the benefit of the government and to the detriment of the taxpayer. He also suggests a strategy of "intentionally flunking" the the SPPA test in one year out of many to cause what would otherwise be PIG net income to remain passive activity income to free up accumulated PAL losses and PAL credits (potentially at high marginal rate benefit) when they exceed the consequence of the resulting NIIT liability (at a low 3.8% marginal rate detriment).

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the activity so as to avoid characterization as passive activity, or (ii) dispose of the activity permitting both deduction of suspended PAL losses and suspended PAL credits. This is because SPPA recharacterization only applies to what would otherwise be passive income from a passive activity income, and does not refer to credits. In other words, the SPPA rules do not recharacterize the activity itself as other than passive. Therefore credits remain passive activity credits unaffected by the SPPA rules.

Another anti-PIG rule provides the rental real estate activity will be nonpassive if less than 30% of the unadjusted basis of rental property is depreciable under Code Section 167.[19] For example, net taxable income from a ground lease will not be from a passive activity. However, since such activity is classified as portfolio income,[20] it remains NII.[21]

Does gain on the sale of an interest in an SPPA would avoid NIIT? Since it appears gain from the sale of the business by the SPPA entity may be recharacterized as nonpassive, it would violate the spirit, if not the mandate, of Code Section 1411(c)(4)(A) to treat the sale of the interest in the entity differently. Hopefully, the final regulations will confirm this result.

IV. THE GOOD AND BAD OF PARTICULAR ACTIVITY, BUSINESS FORMS AND TAXPAYER STATUS.

A. RULES ORGANIZED BY BUSINESS OR INVESTMENT ACTIVITY:

1. Rental Real Estate Activity Not to Affiliates. (3.8% Taxes avoided only if taxpayer is a Real Estate Professional.)

1. There is no self-employment tax (SECA) on rental real estate activity, whether or not the activity is a TorB, unless the taxpayer is a dealer (except for agricultural rental). Code Section 1402(a)(1). Sale by a dealer will be subject to SECA. Code Section 1402(a)(3)(C)(iii).

2. The NIIT will apply to a rental real estate activity UNLESS the taxpayer is a Real Estate Professional (this status is discussed below) AND either:

   (i) the taxpayer participated for more than 500 hours in a rental real estate activity in the year or he participated in such rental real estate activities for more than 500 hours in any 5 of the last 10 years (Reg. Section 1.1411-4(g)(7)(i)["Safe Harbor"];[22] or

   (ii) the rental real estate activity is a TorB and the taxpayer satisfies one of the seven material participation tests described above with respect to the rental activity (Reg. Section 1.1411-4(g)(7)(iii); Part 5.E.iii., Summary of Comments and Explanation of

[19] Reg. Section 1.469-2T(f)(3) and its Example.

[20] Reg. Section 1.469-2(f)(10).

[21] Reg. Section 1.1411-5(b)(2)(iii).

[22] Reg. Section 1.1411-4(g)(7)(i). Grouping under Reg. Section 1.469-9(g) may be necessary to satisfy the safe harbor test.

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Provisions to the Regulations (REG-130843-13))(this TorB status is discussed below).[23] The taxpayer who is a real estate professional may elect to treat all interests in rental real estate as one activity. Apparently the sole purpose is to affect the computation of hours under the material participation test.[24] That election is binding thereafter, but it will not apply in a year when the taxpayer is not a real estate professional. Code Section 469(c)(7)(A)[flush language]. The flush language, in isolation, could be read to preclude rental real estate taxable income from limited partner interests from avoiding the NIIT. The regulations appear to provide otherwise if any of material participation tests (1), (5), or (6) are met with respect to the activity. Reg. Section 1.469-5T(e)(2). If the election is made to treat all rental real estate as one activity, then the sale of one property would not free up suspended losses with respect to such property. However, if sale occurs during a year when the taxpayer is not a real estate professional, then the "grouping" will not apply and logically the suspended losses may be taken, and perhaps even if the year when the taxpayer is not a real estate professional follows the year of sale.

Real Estate Professional**.** Reg. Sec. 1.1411-4(g)(7) defines a **Real Estate Professional** to be as defined in Code Section 469(c)(7)(B), which provides:

(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in **real property trades or businesses** in which the taxpayer **materially participates**, and

(ii) such taxpayer performs more than 750 hours of services during the taxable year in **real property trades or businesses** in which the taxpayer **materially participates**.

In the case of a joint return, the requirements of the preceding sentence are satisfied by a spouse if either spouse separately satisfies such requirements, except that only for purposes of the material participation test, the activities of one spouse may be attributed to the other. Code Section 469(c)(7); Code Section 469(h)(3) and (5); Reg. Section 1.469-5T(f)(3). If spouses file married separate returns, a spouse must separately satisfy the real estate professional test requirements of Code Section 469(7)(B) with respect to: (i) performing more than one half of his or her personal services and (ii) more than 750 hours in real estate trades or businesses, but can satisfy the material participation test by attribution of the spouse's performance. *Oderio v. Comr*, TC Memo 2014-39.

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[23] For PAL purposes, however, all rental real estate activity is deemed to be in a TorB. Reg. Section 1.469-9(b)(1).

[24] CCA 201427016, see fn.30. The author cannot discern an advantage to such grouping for NIIT purposes, although it can affect PAL treatment. **In Stanley R.E. Stanley, DC Ark., 2015-2 ustc ¶50,560 STANLEY v. U.S., Cite as 116 AFTR 2d 2015-XXXX, (DC AR), 11/12/2015 (IRS non acquiescence 10-17?)**, the court held that limiting rental real estate grouping for purposes of determining material participation under Reg. Section 1.469-9(e)(3) did not apply to otherwise limit grouping to avail the taxpayer to the exception to the PAL rules (and therefore the NIIT rules). Reg. Section 1.469-4(c) and (d)(1).

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Services as an employee will not be treated as performed in real property trades or businesses unless the taxpayer is a five-percent owner of the employer as described in Code Section 416(i)(1)(B)[generally 5% of corporate stock value or voting power, or 5% of capital or profits if not a corporation, either applying modified Code Section 318 attribution]. Code Section 469(c)(7)(D)(ii); Reg. Section 1.469-9(c)(5); *Calvanico v. Commissioner*, T.C. Summary Opinion 2015-64.

If the rental real estate grouping election has been made pursuant to Reg. Sec. 1.469-9(g), then the grouping should apply for purposes of the both the satisfaction of the real estate professional test of Code Section 469(c)(7)(B) and satisfaction of the general material participation test of Code Section 469(c)(1). If the real estate professional test is not satisfied, then the grouping election pursuant to Reg. Sec. 1.469-9(g) will not be effective, and only the grouping rules of Reg. Sec. 1.469-4 will apply.

Trade or Business of Real Property and Rental Real Estate Activity. **Real property trades or businesses** include: development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management leasing, or brokerage trades or businesses. Code Section 469(c)(7)(C). For a rental real estate activity to be a TorB, certain actions are important, either to avoid or to perform. For example, to assist in establishing a rental activity TorB a landlord should avoid triple net leases. There must be activity sufficient for rental real estate activity to constitute a trade or business. This issue is not clearly settled.[25] A fair amount of authority holds that one rental property is sufficient to constitute a TorB. Recasting a triple net lease as a gross lease in which the taxpayer lessor pays properties taxes, etc. may be sufficient for her to report the activity as a TorB. There must be expenses, but how much? Ideally there should be something else: multiple properties, other services, but not too much to be treated as being more than rental activity that would implicate application of SECA.

2. Real Estate and other Rental Activity to Affiliates.

If the real estate or other property, such as equipment, is rented to a partnership, LLC, S Corporation or a Section 469 C Corporation (see p.8), and, perhaps other C Corporations (see p.10), in which the taxpayer is an owner for use in the entity's TorB, then the taxpayer will treat the activity as part of the TorB to avoid the NIIT. If the taxpayer *materially participates* in the lessee's TorB, then the taxpayer will be treated as materially participating in a TorB rental activity and avoid the NIIT on the rental income.[26] If the rental is of real estate it will also avoid SECA, both because it is rental real estate and because it is

[25] The topic of whether rental real estate activity is a trade or business is beyond the scope of this article. There are many good discussions of this issue. A succinct discussion can be found in this publication: Hamill, *The Section 1411 Surtax and the Real Estate Professional*, Practical Tax Strategies, Vol. 92, Number 03, March 2014. See also PLR 9840026.

[26] Reg. Section 1.469-2(f)(6). Note that material participation in the TorB is necessary, and significant participation is not sufficient*, and it only applies to net rental activity income and not loss*. This regulation is often referred to as the "self-rental rule" or "self-charged rent."

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not a TorB. The same result if personal property is so leased if it does not constitute a TorB. The taxpayer does not need to be a Real Estate Professional in this self-charged rental real estate situation. Reg. Section 1.1411-4(g)(6), following Reg. Section 1.469-2(f)(6) and, concerning Section 469 C Corporations, Reg. Section 1.469-4(a). See also *Schumann*, TCM 2014-138. So when the taxpayer materially participates in the TorB, the 3.8% Taxes on the rental real estate net income can be avoided.

3. Grouping Activities and Regrouping of Activities.

Grouping activities and regrouping of activities under the Code Section 469 Passive Activity Loss rules (PAL rules) is permitted on 2014 tax returns if there is otherwise NIIT liability in that year. Grouped activities are treated as one activity for all NIIT purposes. A taxpayer that is an individual, estate or trust may regroup in 2013 instead of 2014. Reg. Section 1.469-11(b)(3)(iv); Reg. Section 1.1411-5(b)(1) incorporates the general grouping regulation of the PAL rules: Reg. Section 1.469-4; Reg. Section 1.1411-5(b)(3)Ex.2 [applies the grouping rules under Code Section 469 to the NIIT]. The activity (other than rental activity) must rise to the level of a TorB to be grouped. TorB activities and rental activities may be grouped "if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469." Reg. Section 1.469-4(c). A Section 469 entity (S corporations, partnerships and Section 469 C corporations) may group activities. But if they do not group activities so that they remain separate, then the shareholders or partners can group such activities. However, shareholders or partners cannot ungroup activities grouped by section 469 entities, but can further group them.[27] Grouping is not permitted to affect the self-rental rule of Reg. Section 1.469-2(f)(6), discussed in the immediately preceding topic.[28]

Rental activity, whether real estate or other tangible personal property, does not have to rise separately to a TorB to be able to be grouped with other groupable activities. Reg. Section 1.469-1T(e)(3) [part of definition of passive activity]. However, rental activity can be grouped with TorB activity <u>only if</u>:

(i) the activities constitute an "appropriate economic unit" described above; <u>and</u>

(ii) one of the following is true: (1) the rental activity is insubstantial in relation to the TorB activity, (2) the TorB activity is insubstantial in relation to the rental activity, or (3) the activities are owned by the same persons in the same percentages [Reg. Section 1.469-4(d)].

If the taxpayer elects to group all rental real estate activities as one activity pursuant to Reg. Section 1.469-9(g) and any interest in such activities is held as limited partnership interests that comprise ten percent or more of the gross rental real estate income of the taxpayer, then the material participation test is not met as to any of such interests unless the taxpayer satisfies the 500 hour test of paragraph (1) or paragraph (5) or (6).[29] Grouping under Reg. Section 1.469-9(g) may be necessary to satisfy the safe

[27] Reg. Section 1.469-4(d)(5). See also 1.469-4(c)(3) Ex.2.

[28] *Carlos v. Comr*, 123 T.C. 275 (2004).

[29] Reg. Section 1.469-9(f); Reg. Section 1.469-5T(e)(2); Reg. Section 1.469-5T(a).

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harbor real estate professional test for rental real estate of Reg. Section 1.1411-4(g)(7)(i).[30] In such case, the ten percent rule may not be of consequence since the 500 hour test is the only test applicable.

Grouping under Reg. Section 1.469-4 does not control determination of the taxpayer's real property trades or businesses under Reg. Section 1.469-9(d) for purposes of satisfying the real estate professional test (to be a qualifying taxpayer under Reg. Section 1.469-9). Instead, grouping is based on all the relevant facts and circumstances. "A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services." Reg. Section 1.469-9(d)(1). Grouping under Reg. Section 1.469-9(g) also does not control for that purpose. CCA 201427016.

Grouping is important and must not be overlooked. See the Example on page 8.

4. Loans <u>to Affiliates</u>.

If a taxpayer lends to a partnership, LLC or S Corporation, or, likely, a Section 469 C Corporation, in which he is an owner for use in the borrower's TorB, then a share of the interest income will be treated as TorB income that will not be subject to the NIIT if he materially participates in the entity's TorB. The share of the income NIIT free is his share of the entity's self-charged deductions divided by the greater of (i) his share of the interest received or (ii) the total self-charged deductions of the entity. Reg. Sections 1.469-7(c) and 1.1411-4(g)(5). Since it is lending activity and it is not a TorB, there is no SECA. Code Section 1402(a), including paragraph (2) thereof. Subject the formula limitation above, the the 3.8% Taxes are avoided.

The entire interest amount can avoid the NIIT if the entity is a tax partnership and, instead of a loan, the note is converted to a capital interest and amounts are paid to the taxpayer as a preferred profits interests, which will be fully protected from the NIIT if the taxpayer materially participates in the TorB entity. Such type of payment, of course, creates the possibly that it will not be made if there is not profit. A preferred profits interest is not a guaranteed payment under Code Section 707(c). See **Paragraph 5** of **this Part A** below. The other method of compensating the contributor is in the form of a guaranteed payment. As discussed below in **Paragraph 5** of **this Part**, a guaranteed payment is characterized as interest under the PAL regulations, and might be characterized as self-charged interest under Reg. Section 1.1411-4(g)(5).

But unless the TorB entity is an S Corporation or there is an S Corporation Blocker Arrangement (see **Paragraph 4** of **Part B** and **Paragraph 5** of **Part C**, below), the effect of avoiding the NIIT through a contribution of the loan to capital may be essentially offset by increase in the SECA tax.

[30] Reg. Section 1.1411-4(g)(7)(ii)(B). But see CCA 201427016, ruling that for PAL purposes, grouping under Reg. Section 1.469-9(g) does not apply for determining real estate professional status (i.e., "qualifying taxpayer" under Reg. Section 1.469-9(b)(6) and (c)), but only for satisfying the material participation test alone.

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5. Guaranteed Payment for Capital is Interest for PAL Purposes, and may also be so for NIIT Purposes .

A guaranteed payment is a payment due regardless of profits of the TorB entity and is treated as made to one not a partner of the tax partnership for purposes of Code Section 61(a) and other sections. Code Section 707(c). If made for use of capital it is treated as the payment of interest for PAL purposes. If it is made for services of an individual it is subject to SECA. The NIIT Proposed Regulations can be read as precluding the ability to avoid NIIT on guaranteed payments from tax partnerships unless subject to SECA tax. Prop. Reg. Section 1.1411-4(g)(10). But a close reading leads one toward the opposite conclusion – that the guaranteed payment is a payment of interest to the tax partner receiving the payment and is self-charged interest for purposes of Reg. Section 1.1411-4(g)(5). There is no case law regarding this issue located by the author. Therefore, the existing authority is limited to the regulations promulgated under Code Sections 469, 707, and 1411 and the proposed regulations promulgated under Code Section 1411.

In the passive activity loss (PAL) regulations promulgated under Code Section 469, there are at least two sections that treat guaranteed payment for capital as interest paid to one not a partner. Reg. Section 1.469-2(e)(2)(ii); Reg. Section 1.469-7(a)(1).

Prop. Reg. Section 1.1411-4(g)(10) categorizes guaranteed payments for capital as NII within the meaning of Code Section 1411(c)(1)(A)(i). The exception mentioned is Prop. Reg. Section 1.1411-4(g)(11), which deals with Code Section 736 payments to a retiring partner or deceased partner's successors. It is the author's belief that the exception was not an exclusive exception, but that it is necessary for purposes of dealing with Code Section 736, and not intended to foreclose the application of the self-charged interest provisions of Reg. Section 1.1411-4(g)(5). In other words, the proposed regulation merely places the guaranteed payment into the NII holding pen, while the PAL regulations characterize the payment as interest, and the self-charged interest NIIT regulation is then applied to remove it from the NII holding pen if the taxpayer materially participates. The self-charged interest NIIT regulation refers to interest that is within the meaning of Code Section 1411(c)(1)(A)(i) and then proceeds to remove it from characterization as NII. This methodology is also followed by the self-charged rental regulation – Reg. Section 1.1411-4(g)(6), and by the NIIT retiring and deceased partner regulation - Prop. Reg. Section 1.1411-4(g)(11). Looking at it another way, if the taxpayer materially participates in a trade or business, why should a payment for the use of capital be taxable if a guaranteed payment is made, but be non-taxable if the capital were loaned to the business? None of the Regulations, the Proposed Regulations, or the preambles to them articulate any such purpose or intent.[31] In fact the preamble to the Proposed Regulations acknowledges the interest aspect of guaranteed payments:

> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance

[31] The author thanks ACTEC Fellow Steven B. Gorin, Esq. for his analysis of the regulations and related authority.

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under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

The characterization of guaranteed payments as for capital or services may be subject to the reasonableness of the amounts. Reg. Sections 1.707-3 and 1.707-4.

Due to the lack of clarity that guaranteed payments will be treated as interest for purposes of the self-charged interest rules, taxpayers are advised to consider whether alternative planning opportunities are available.

6. Licenses of Patents, IP, or Trade Names <u>to Affiliates</u>.

There is no provision for special treatment to avoid the NIIT on royalty or licensing fee taxable income of taxpayers from another commonly owned entity for use of the licensed property in its TorB. Therefore the NIIT will apply to such self-charged royalties for licensing patents, intellectual property, and goodwill, such and trade names or trademarks, regardless of whether the licensor materially participates in the TorB entity's activity (unless the licensing activity alone constitutes a TorB in which the taxpayer materially participates). **To avoid the NIIT on royalties, the Intellectual Property rights could be owned by the TorB entity in which the taxpayer materially participates. Then, if the entity is a tax partnership, special payments could be made to compensate the contributor in one of two ways. One method would be compensation made as a preferred profits interest to the taxpayer (with the economic risk that there will not be sufficient profits).** A profits interest is not a guaranteed payment by definition, and therefore is treated as a distributive share from the LP or LLC, which payment will not be subject to the NIIT if the taxpayer member or partner materially participates in the TorB entity. The other method would be to compensate the contributor in the form of a guaranteed payment. As discussed above in **Paragraph 5** of **this Part**, a guaranteed payment is characterized as interest under the PAL regulations, and might be characterized as self-charged interest under Reg. Section 1.1411-4(g)(5).

But unless the TorB entity is an S Corporation or there is an S Corporation and Limited Partnership Blocker Arrangement (see **Paragraph 4** of **Part B** and **Paragraph 5** of **Part C**, below), the effect of avoiding the NIIT through a contribution of the property to capital may be essentially offset by increase in the SECA tax.

7. Service Business Activity.

Tax partners of tax partnerships in the TorB fields of <u>health, law, engineering, architecture, accounting, actuarial science or consulting</u> (referred in this discussion as "**Professional Services**") very possibly will have all of their income from the activity treated as self-employment income (SECA) to the extent not paid to them as W-2 wages, regardless of the business entity. *Renkemeyer, Campbell & Weaver, LLP v. Comr*, 136 TC 137 (2011). See also, *Riether v. United States*, 919 F. Supp.2d 1140 (D.N.M. 2012), and CCA 201436049.

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In *Renkemeyer*, the Tax Court reviewed legislative history, and concluded that Code Section 1402(a)(13) exclusion of limited partners from SECA was intended for "individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time)" and not to exclude the distributive shares of lawyers that arose from of the LLP law firm, almost all of whose "revenues were derived from legal services performed by [them] in their capacities as partners." The court did not address or analyze the fact that the interest of the taxpayer was an LLP interest, and not a limited partner interest. Nonetheless it assumed the best fact for the taxpayer – that it was a limited partner interest – and still held that SECA applied. This is the case for all limited partners and LLC members if the Prop. Reg. Sec. 1.1402(a)-2(h)[subjecting both LLC member interests and LP limited partner interests to SECA tax in certain circumstances](the "SECA Proposed Regulations") is ever finalized as presently written. However, the author has found no cases expressly holding that a limited partner in a limited partnership was found subject to SECA or FICA even when the distribution from the limited partnership was based solely upon services (other than **Professional Services**) provided by the limited partner. Members of LLCs have no express statutory protection from SECA, and the proposed regulation would seem to preclude avoidance if the member materially participates. Prop Reg. Sec. 1.1402(a)-2(h)(2)(iii), (5) and (6). However, the sale of the business might escape SECA and the NIIT if structured correctly. Other services TorBs that are not Professional Services might be able to avoid SECA and NIIT to the same extent as other business activity – see **Other Trades or Businesses Generally** immediately below.

8. Other Trades or Businesses Generally, including Nonrental Real Estate Activities (that are not Professional Services).

An owner could be subject to one of the 3.8% Taxes **unless** he:

(1) Materially Participates in a TorB, **and**

(2) is one or both of the following:

(i) he is a limited partner (and not a general partner) in a limited partnership not performing Professional Services (determined without consideration of the SECA Proposed Regulations) to the extent not receiving a guaranteed payment, or

(ii) he is a shareholder in an S Corporation, and is reasonably compensated as a W-2 officer or employee (such amount subject to FICA), with the excess profit distributed as dividends, free of the 3.8% Taxes.

9. Sale of a business.

The sale or liquidation of a business (other than rental activity), if other than a C Corporation's stock, may avoid the NIIT if the taxpayer materially participated in the business at the time it is sold.[32] If the

[32] Prop. Reg. Section 1.1411-7. The proposed regulation mentions transfers of partnership and S Corporation interests as eligible to avoid NIIT. Even though, under the reasoning of *Schwalbach*, activity by a shareholder of a

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business is real estate rental activity, then the real estate professional test must also be met. Code Sections 1411(c)(1)(A)(iii), 1411(c)(2)(A), and 1411(c)(4). Gain on the sale should generally avoid SECA tax regardless of material participation or whether it is a C Corporation. See **Paragraph 5** of **Part B** below. It is possible the sale or liquidation will generate ordinary taxable income for various reasons (e.g., for tax partnerships, Code Section 751 – "hot assets").

B. RULES ORGANIZED BY FORM OF BUSINESS AND STATUS OF TAXPAYER:

1. Sole Proprietorships (Schedule C) – WILL NOT WORK to avoid the 3.8% Taxes.

This form of ownership will cause the entire activity to be subject to SECA, one of the 3.8% Taxes, unless it is rental real estate TorB activity (then it is reported on Schedule E, not C). If the activity is rental real estate and taxpayer is a Real Estate Professional and either (i) satisfies 500 hour safe harbor or (ii) activity is a TorB, then neither SECA nor NIIT is imposed. Reg. Section 1.1411-4(g)(7). If so then - see **Rental Real Estate Activity <u>Not to Affiliates</u>** above.

2. Limited Partner - COULD WORK to avoid the 3.8% Taxes if Materially Participates or Significantly Participates.

To the extent a taxpayer is a limited partner and if not a general partner, he is not subject to SECA on limited partnership income, except for guaranteed payments under Section 707(c). Section 1402(a)(13). (A guaranteed payment from a partnership is a payment for services or capital not dependent upon the income of the partnership.) A limited partner will likely not avoid SECA if the individual limited partner is providing **Professional Services,** or even if nonprofessional services. *Renkemeyer, Campbell & Weaver, LLP v. Comr,* 136 TC 137 (2011). In *Renkemeyer*, the Tax Court reviewed legislative history, and concluded that Code Section 1402(a)(13) exclusion of limited partners from SECA was intended for "individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time)" and not to exclude the distributive shares of lawyers that arose from of the LLP law firm, almost all of whose "revenues were derived from legal services performed by [them] in their capacities as partners." The court did not address or analyze the fact that the interest of the taxpayer was an LLP interest, and not a limited partner interest. Nonetheless it assumed the best fact for the taxpayer – that it was a limited partner interest – and still held that SECA applied.[33]

Section 469 C Corporation is subject to the material participation test for purposes of the anti-PIG self-rental rule, it is not likely that sale of the stock is eligible to avoid NIIT even if the shareholder materially participates in the corporation's activities.

[33] In CCA 201436049, a limited liability company providing investment management services treated members as employees with W-2 wages, reporting remaining K-1 income to such members as not subject to SECA. IRS Chief Counsel treated distributive shares of the members as subject to SECA, citing *Renkemeyer*. Apparently, the W-2 income treatment was left standing, although such was "mislabeled." The LLC was characterized as a partnership in the advice, and it did not distinguish LLCs from limited partnerships. See also *Riether v. United States*, 919 F. Supp.2d 1140 (D.N.M. 2012).

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If the SECA Proposed Regulations are finalized, then the limited partner would have to jump through additional hoops described for LLC members below to avoid the SECA tax. For example, if the limited partner performs more than 500 hours in the limited partnership's TorB activity, then the proposed regulations would treat his limited partner income as other than limited partner income for purposes of SECA. Prop. Reg. Section 1.1402-2(g) and (h).

If the limited partner is an employee of a corporate general partner (whether a C Corporation or an S Corporation), whether or not a shareholder, and satisfies the material participation tests (1), (5), or (6) in the limited partnership's TorB by providing services to the corporation, or merely significantly participates, then the NIIT is avoided with respect to the limited partner interest income.[34] "[A]ny work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated as participation of the individual in the activity." Reg. Section 1.469-5(f)(1); Reg. Section 1.469-5T(k) Ex.(2).

3. LLC Member – MIGHT NOT WORK to avoid the 3.8% Taxes unless both (i) Materially Participates <u>and</u> (ii) others with significant interests of the same class do not Materially Participate.

For planning purposes it should be assumed that an LLC member of an LLC that does not elect corporation income tax status will have a difficult time avoiding the 3.8% Taxes. The reason is that the proposed regulation that permits the LLC member to be treated as a limited partner to avoid the SECA tax conditions that status upon the member not materially participating. Prop. Reg. Sec. 1.1402(a)-2(h)(2)(iii), (5) and (6). **It is important to know that the SECA Proposed Regulations are <u>neither</u> binding upon the taxpayer <u>nor</u> the IRS** until published as final in the federal register. Prop. Reg. Sec. 1.1402(a)-2(j). (There is an exception under the SECA Proposed Regulations if the LLC member materially participates and there are other members with significant interests who do not.) <u>Note, again: the SECA avoidance for LLC members is based on the non-effective SECA Proposed Regulations.</u>

A taxpayer is not treated a as limited partner under the SECA Proposed Regulations unless the taxpayer passes muster under Prop. Reg. Sec. 1.1402(a)-2(h)(2), (3) or (4).

An LLC should be able to convert to a limited partnership without adverse tax consequences. Reg. Section 1.708-1(c)(1)(larger tax partnership is deemed to survive "merger" and its EIN continues); Reg. Section 1.708-1(c)(2)(statement is to be attached to return).

4. Shareholder of S Corporation – WILL WORK to avoid the 3.8% Taxes if Materially Participates or Significantly Participates to the extent dividends are not recharacterized as disguised compensation.

Income allocations and distributions (referred to as "dividends" in this discussion) from S corporations that are not treated as compensation are deemed not derived from any TorB, and therefore are not subject to the SECA tax. Rev. Rul. 59-221, 1959-1 CB 225; *Ding v. Comr*, T.C. Memo 1997-435, 74 TCM 708, *aff'd*, 200 F.3d 587 (9th Cir. 1999). However, reasonable compensation must be

[34] Reg. Section 1.469-5T(e)(2).

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paid to a shareholder who provides services to the S Corporation or the IRS can treat some or all of the dividends as wages. *Radtke*, 861 F.Supp 143 (DC Wis., 1989), *aff'd,* 895 F2d 1196 (CA-7, 1990); *Grey*, 119 TC 121 (2002), 93 Fed Appx 472 (CA-3, 2004). In *David E Watson, P.C.*, 757 F.Supp. 2d 877 (DC Iowa, 2010), *aff'd,* 668 F3d 1008 (CA-8, 2012), the court found reasonable compensation to be $91,044, as determined by the IRS's expert, and not the taxpayer's claimed $24,000. LLCs can elect to be treated as S Corporations.

5. Sale or Liquidation of interest in Tax Partnerships or S Corporation – WILL WORK to avoid the 3.8% Taxes if Materially Participates or Significantly Participates in the Business of the Entity at that time.

If the NIIT is avoided with respect to an business due to material participation, then the sale or liquidation of the business entity interests, if partnerships, LLCs, LPs, or S Corporations will generally avoid the NIIT as well. Code Section 1411(c)(4); Prop. Reg. Section 1.1411-7; Reg. Section 1.1411-4(d)(4)(i)(B)(1). To avoid the NIIT with respect to the sale or liquidation of real estate rental activity, then the real estate professional test must also be satisfied. Code Sections 1411(c)(1)(A)(iii) and 1411(c)(2)(A). Installment sale gain recognition timing under Code Section 453 will apply, and the NIIT character will be based on the date of sale and will apply to each installment payment. Reg. Section 1.1411-4(a)(1)(iii)); Prop. Reg. Section 1.1411-7(d). Interest on installment sale notes is NIIT. SECA tax generally does not apply to the sale of a business. Code Section 1402(a), including Paragraphs (2) and (3); Reg. Section 1.1402(a)-6(a); and because the sale action is generally not within a TorB activity subject to SECA.

6. Shareholder of C Corporation – WILL NOT WORK to avoid the 3.8% Taxes. There is no exception for Material Participation, EXCEPT for rents and, perhaps, interest from certain C Corporations.

Code Section 1411(c)(1). There is double tax. A C Corporation is not subject to any 3.8% Taxes. Code Section 1411(a). Dividend receipts from a C Corporation cannot avoid the NIIT. Code Section 1411(c)(1)(A)(i); Reg. Section 1.1411-4(a)(1)(i).

Sale of C Corporation stock cannot avoid the NIIT. Reg. Section 1.1411-4(a)(1)(iii). The NIIT regulations do permit exception for certain dispositions of partnership interests or S Corporation stock, but do not provide so for dispositions of C Corporation stock. Reg. Section 1.1411-4(d)(4)(i)(B)(1); Prop. Reg. Section 1.1411-7.

However, it is possible that rentals of tangible property to a C corporation subject to Code Section 469 (a Section 469 C Corporation: a Closely Held C Corporation or a Personal Service Corporation) can avoid NIIT if the lessor is an owner of and materially participates in the TorB of the corporation. Sale of Section 469 C Corporation stock might avoid NIIT. See paragraph entitled: Section 469 C Corporations in **Part III** (p.8).

Section 469 and its regulations are thought not to apply to C Corporations (other than personal service corporations and closely held corporations (Section 469 C Corporations)). Reg. Section 1.469-1T(g). Section 469 and its regulations do apply to a Section 469 C Corporation and its shareholder to cause his material participation in the corporation's TorB to prevent his rental income from the

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corporation being passive activity. See *Stephen Schwalbach, et ux. v. Commissioner*, 111 TC 215 (1998) in **Part III** (p.9). The *Schwalbach* court held that it is not necessary that regulations must expressly permit a C Corporation shareholder to be able to meet the material participation requirement in order for him to do so.

7. Partner or Member Retirement.

If, in compliance with regulations, a tax partner retires, renders no further services, has received all amounts for liquidation of his interest, his remaining receipts from the partnership or LLC are for "payments on account of retirement" pursuant to a written plan covering one or more class of partners, is periodic and paid until death, and he is not receiving any other amounts from the entity, then SECA can be avoided. Code Section 1402(a)(10) and Reg. Section 1.1402(a)-17. The NIIT can be avoided as well. REG-130843-13 - Explanation of Provisions 2.B.iii.b.; Prop. Reg. Section 1.1411-4(g)(11)(iii)(B). If payments are to compensate for liquidation of a partnership interest, then it may still avoid the NIIT if he was materially participating in the entity's TorB on liquidation. Reg. Section 1.469-2(e)(2)(iii)(A). If a partnership is engaged in a personal service activity then the retiring partner is deemed to always be materially participating if he had materially participated in the activity for any three prior taxable years. Reg. Section 1.469-5T(a)(6); Reg. Section 1.469-5T(d). The characterization of payments as for services or capital are subject to the reasonableness of the amounts. Reg. Sections 1.707-3 and 1.707-4. If the payments are

C. PLANNING TO MITIGATE THE 3.8% TAXES: SECA, FICA AND NIIT:

1. Obtain salary surveys, if available for the particular employment, with "documented empirical support using comparative salary data."

– from one article on reasonable compensation - "A New Look at Subchapter S Compensation Strategies, by Alan Bruce Clements, faculty member Kennesaw State University, Business Entities (WG&L), in RIA Checkpoint, 2013.

2. Trust owner of business interest.

To assist a nongrantor trust avoid the 3.8% Taxes, if the trust, through its trustee, can satisfy the material participation requirement of 500 hours, or when applicable, the significant participation requirement of 100 hours, then appoint as trustee an individual who has the capacity to manage the applicable TorB business that the trust owns in whole or in part, and who has specific authority to act for the business entity. See below **PLANNING TO AVOID NIIT TO TRUSTS**.

3. Convert guaranteed payments to preferred profits interests.

If payments to members are guaranteed payments under Code Section 707(c) for use of capital and are disproportionate with other distribution rights, it appears that NIIT will be imposed on some or all of the payment, regardless of material participation. By converting the right to distribution to a special allocation of income, the NIIT may be avoided. See **Paragraph 4** of **Part A** above. Don't forget, SECA may still apply even if NIIT is avoided.

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4. Contribution of patents, IP and goodwill property <u>to Affiliate</u>.

Self-charged royalties and licensing fees to the taxpayer licensor to an affiliate will be subject to the NIIT, even when self-charged interest and rent would not. The ability to avoid both the NIIT and the SECA tax may be problematic in many circumstances. To avoid the NIIT, when the taxpayer materially participates in the TorB entity of which he is an owner, he could contribute the property to the TorB entity. SECA tax may apply to the extent the NIIT doesn't. So to also avoid SECA, the TorB entity should be an S Corporation or in a an effective S Corporation Blocker Arrangement. See **Paragraph 4** of **Part B** above and **Paragraph 5** of this **Part C** below. If an S Corp/LLP combination is used, then the limited partnership could give the materially participating taxpayer a preferred profits interest, which will be NIIT free.

5. Using S Corporation Blockers – with LP and S Corporation combination (S Corporation Blocker Arrangement).

The optimum business structure will vary depending on the specific needs and limitation of useful techniques due to the nature of the existing structures, facts and activity. But there is a default structure that is a good starting point: a Limited Partnership (LP) with an S Corporation as a General Partner owning one Percent of the LP (see the last chart at the end of this article).

<u>Structure and Operation</u>. The S Corporation can act as a block or filter to strip off the 3.8% Taxes. The key management and service providers can be shareholders as well as employees of the S corporation under employment agreements. The compensation will be subject to FICA. The employees can also own some or all of the limited partner interests. If a shareholders/employee materially participates in the business activity, profit in excess of expenses can be distributed free of the 3.8% Taxes to her both as distributions of earnings from the limited partnership as a limited partner, which should avoid SECA pursuant to Code Section 1402(a)(13), and as distributions from the S Corporation as a shareholder.

<u>Purpose of LP is Estate Planning</u>**.** The use of a limited partnership is primarily for estate planning purposes. Firstly, it provides flexibility for future possible transfers to objects of one's bounty. Secondly, and significantly, if the owner dies, the basis of the limited partner interest is stepped up to fair market value. This would also occur if the interest in the business was held entirely as an S Corporation stock interest, so that alone is no reason to use a limited partnership. But there is an important difference between owning an LP interest and owning S Corporation stock. The basis of assets held in an S Corporation are not changed as a result of the death of the shareholder. However, a limited partnership can elect to have the basis of its assets adjusted upward to reflect the increase in basis of the decedent's partnership interest. Code Sections 743 and 754. This can permit greater future depreciation and amortization deductions and reduced ordinary and capital gain to the holders of the decedent's limited partner interests on the future sale of partnership assets. None such benefits would accrue if the owner held only S Corporation shares.

<u>Roll up if SECA Proposed Regulations are Finalized</u>**.** If the IRS finalizes the SECA limited partner proposed regulation as written (Prop. Reg. Section 1.1402(a)-2(g), (h), and (i)), the employee/limited

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partners can contribute tax free their limited partner interest into into the S Corporation and remain protected by the S Corporation blocker against the NIIT if they materially participate in the TorB of the LP, as well remain as protected from SECA and FICA. What is given up is the tax free step up in basis of their respective limited partner interests that occurs upon their death.

Conversion of LLCs. An LLC can elect to be treated as an S Corporation. Reg. Section 301.7701-3. Alternatively an LLC may convert (in some jurisdictions most simply by merger) into a limited partnership without adverse tax consequences. Reg. Section 1.708-1(c)(1)(larger tax partnership is deemed to survive "merger" and its EIN continues); Reg. Section 1.708-1(c)(2)(statement is to be attached to return). These conversions are expedient ways to get to the optimum default structure without retitling existing business assets, risking loss of title insurance coverage, avoiding state, federal and other relicensing requirements, and transferring leases, and may avoid the necessity or advisability of obtaining lender, landlord and other consents required under various covenants.

Create Multiple Entities for Asset Protection. Create separate subsidiaries disregarded for income tax purposes to insulate liability.

6. Withdraw equity or property and lease or loan to TorB entity.

By loaning or renting property that does not constitute a TorB to the TorB entity, Reg. Section 1.1411-4(g)(5) and (6) can permit the interest or rental income to reduce taxable income in the TorB entity and increase it as NIIT free and SECA tax free income if the taxpayer materially participates in the TorB entity activity. The distribution of the property from the TorB entity will generally not cause taxable gain if the entity is a tax partnership (LP or LLC). However, if an S corporation, then there will be gain if the property distributed has a basis less than than its fair market value. If a C Corporation, then any distribution will also create a taxable dividend, unless the corporation has no earning and profits. The best means to effect the creation of an interest bearing loan in favor of one or more shareholders, member or partners will vary will vary. Lack of basis and so-called "negative basis" in the TorB entity interests held by the owners must be considered.

7. Managing Grouping.

Grouping of activities may be very important if multiple brother-sister entities are involved. Regrouping once grouping has been made is difficult, so it should be done only when considering the consequences over the expected duration of the relevant activities. If there are many ungrouped activities that could be grouped, then perhaps neither the 500 hour test of paragraph (1) nor the "significant participation" test of paragraph (4) of the material participation tests (see PART III on p.6, and the example on p.8) will be satisfied if grouping is not carefully made. A limited partner cannot group a limited partner interest to avoid the NIIT by satisfying the paragraph (4) "significant participation" test but not the paragraphs (1), (5), or (6) tests, so grouping may not assist a limited partner to achieve material participation. However, it might be enough just to satisfy the "significant

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participation passive activity" test discussed on page 11.[35] There may be adverse passive activity loss consequences to grouping that reduces NIIT. The grouping of rental real estate is generally implemented pursuant to Reg. Sec. 1.469-9(g).

Reg. Section 1.469-5T(e)(2)(the exception for limited partner interests literally applies only for purposes of material participation and not for significant participation).

D. PLANNING TO AVOID NIIT TO TRUSTS:

Trusts that are not grantor trust for income tax purposes are not subject to SECA or FICA. However they can be subject to the remaining 3.8% Tax, the NIIT. The highest tax bracket, 39.6% plus the 3.8% NIIT apply to trust taxable income in excess of $12,300 in 2015. Assume a high state income tax rate, and the marginal tax rate approaches 50%.

One way to avoid the tax is to distribute trust income to beneficiaries in or for the same taxable year. This reduces both the regular income tax and NIIT. If the beneficiary may have adjusted gross income below the $200,000 threshold for incurring the NIIT (or $250,000 if married), the tax rate savings will likely be well over 8% of the income shifted, and could be multiples of that percentage. Distributable Net Income ("DNI") for any taxable year may be shifted to beneficiaries if amounts are distributed or deemed distributed to them with respect to such year. Code Sections 643, 651, and 661.

Amounts distributed or deemed distributed from a trust that is required to distribute income currently (referred to as a "simple" trust in Reg. Section 1.651(a)-1) "shall have the same *character* in the hands of the beneficiary as in the hands of the trust." Code Section 652(b); Reg. Section 1.652(b)(1). That language also appears in the Code and regulations concerning distributions from "complex trusts" (i.e., trusts described in Code Section 661(a)). Code Section Section 662(b); Reg. Section 1.662(b)-1. The provisions regarding complex trusts discuss the proration of the *class* or *class of items* of income distributed, which is not mentioned in the Code or regulations regarding simple trusts. Likely, this is because allocating classes of income between the trust and its beneficiaries is not applicable to simple trusts, since all items treated as income would be deemed distributed. An IRS official in a telephone call with practitioners this year indicated that the character of DNI as active or passive for NIIT purposes is determined at the trust level, at least as to distributions from simple trusts.[36] However, there is no direct authority as to whether the character of distributed income from a trust includes the attributes of material participation or status as a real estate professional. Nor is there any authority as to whether the activity of a trust can be attributed to a beneficiary receiving taxable distributions for a taxable year so as to be aggregated with his or her activity for purposes of Code Sections 469 and 1411.

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[35] Reg. Section 1.469-2T(f)(2); Reg. Section 1.469-5T(e)(2)(the exception for limited partner interests literally applies only for purposes of material participation and not for significant participation).

[36] 'Aragona Trust': New Weapon in Fight To Avoid Section 1411 Investment Tax, Daily Tax Report (BNA) (April 1, 2014).

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Distributed distributable net income (DNI) that is NII reduces the trust's NII, and to that extent the beneficiary has NII. Reg. Section 1.1411-3(e); Reg. Section 1.1411-4(e). The character of trust income as NII is determined at the trust level, and if DNI distributed is not NII to the trust it will not be NII to the beneficiary.

Another means that might be available for some trusts to avoid the NIIT is if the trade or business or rental real estate activity income of, or allocated to, the trust is deemed not to be passive activity income. A trust avoids such characterization regarding a trade or business activity only if it can be found to *materially participate* in a trade or business activity. Code Section 469(c) and Code Section 1411(c)(2). Code Section 469(h) defines material participation. Correspondingly, a trust can avoid the NIIT with respect to rental real estate activity if it is a *real estate professional*. Reg. Sec. 1.1411-4(g)(7) defines real estate professional to be as defined in Code Section 469(c)(7)(B). The question is: whose activity regarding the trust is examined to determine if the trust materially participates or is a real estate professional? The IRS position is that the trustee itself must so act. TAM 200733023 and PLR 201029014. It views the applicable persons to be tested as being only those who have authority and the legal power to act and bind the trust as the trustee and not in any other capacity. However, a US District Court held that material participation is measured by the applicable business activity as a whole, looking at the trust's workers' activities and not solely at the trustee. *Mattie K. Carter Trust v. US*, 256 F. Supp. 2d 536 (DC Tex. 2003). So if a trust has business activity or is a tax partner in a trade or business tax partnership, such as a limited liability company, the safest approach is to design a trust to permit the trustee to divide authority, and thereby also exculpate the trustees who are not actively running the business. A recent case discussed below expressly held that not all trustees must actively participate to deem the trust to so act.

In TAM 201317010 the IRS reiterated its position that the trustee himself must materially participate. The IRS cited the legislative history of Code Section 469. The thorough analysis by the IRS in the technical advice memorandum is worth reciting:

> The focus on a trustee's activities for purposes of Code Section 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] ... are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous

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should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).

Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of Code Section 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.

A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F2d 98 (9th Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under Code Section 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of Code Section 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of Code Section 469(h) for purposes of Code Section 56(b)(2)(D) for the tax years at issue.

More recently, the Tax Court held for the taxpayer in *Frank Aragona Trust v Comr*, 142 T.C. 165 (2014). In *Aragona*, the court ruled that trusts can satisfy the the real estate professional test of Code Section 469(b)(7) and that activities of less than all trustees in capacities other than as trustees can be attributed to the trust for purposes of satisfying the material participation test. The court noted that under Michigan law, the trustees acting as employees of an entity participating in the activity continued to have fiduciary duties owing to the beneficiaries of the trust and could not properly act in derogation of those duties as employees of the entity. This observation by the court should be a guide in planning. To the extent that a trustee is acting in another capacity and the person's activities are intended to satisfy the material participation test or the real estate professional test as trustee of the trust, the

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contract or arrangement should provide that the duties of the person in so acting will include the duty to act for the benefit of the trust as a trustee of the trust would so act. Specifically reserved by the court was whether the activities of employees and agents of the trust who are not trustees can be attributed to the trust: "We need not and do not decide whether the activities of the trust's nontrustee employees should be disregarded."

Section 469 C Corporations are the only taxpayers other than individuals or trusts subject to PAL rules. As stated earlier, they are the only entities other than trusts for which determining work that is participation is relevant. A corporation is deemed to materially participate in its business activity if individuals holding more than 50% in value of the stock of the corporation each materially participate in the activity.[37] Such shareholders are not required to have voting control in order for such individuals' work to satisfy the material participation test. There is no rationale for requiring trustees to have voting control of the trust in order to have their work in a business activity owned by the trust be deemed participation of the trust in the activity, when such is not required of owners of Section 469 C Corporations to have their work so attributed to the corporation. There are no other statutory provisions defining participation of taxpayer entities per se.

One issue not addressed in the authority cited above is whether a trust carrying on business can be characterized as an association taxable as a corporation under Reg. Section 301.7701-4(b). Reg. Section 301.7701-4(a) gives comfort. It provides, in part, that a trust will not be characterized as a corporation if the purpose of the trust "is to vest in trustee responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility…".

Finally, to the extent the trust is receiving distributions from IRAs or qualified plans, NIIT is not imposed. Code Section 1411(c)(5); Reg. Section 1.1411-8.

V. SUMMARY WITH EXAMPLE:

There are many areas in which the applicable tax rules are uncertain. The uncertainty includes whether the IRS can apply rules regarding NIIT that differ from the current PAL Regulations. With that said, the following summarizes some important matters that should not be overlooked.

If the business is other than a pure service business owned by the material service providers, then there may be a significant advantage to electing to become an S Corporation. The distributions of its profits to the actively participating owners may avoid the 3.8% NIIT and the self-employment tax. Here is an example: Assume an owner's, Bob's, share of distributions is $1,200,000, and that it can be established that the compensation necessary to hire another to perform his services running the business is $200,000. Assume he spends enough time working in the business such that he "materially participates" in the business. If the business is an S Corporation, he could "W-2" himself $200,000/yr., subject to payroll taxes. However the excess $1,000,000 would be allocated to him and then distributed

[37] Section 469(h)(4); Reg. Sec. 1.469-1T(g)(3).

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free of the 3.8% Taxes (both employment tax and the NIIT) because of his material participation) and avoid $38,000 in tax each year.

It would be difficult, and likely not possible, for a trade or business activity that is not rental real estate activity to hit the "sweet spot" of avoiding both self-employment tax and the NIIT if the activity is held in a tax partnership (such as an LLC) unless it is a limited partnership with an S Corporation general partner.

If the business is then sold, generating $5,000,000 in gain, then that, too, could avoid the 3.8% Taxes, saving another $190,000. If the children own an interest, and can become bona fide employees before the sale, devoting necessary time and effort, they may also qualify as materially participating and also avoid the taxes on their share of the gain, which may well be high enough to be in "NIIT Land" in that year. Consideration should be given to an installment sale as to specific sellers under Code Section 453 in order to spread the gain over years if that may cause their respective taxable income to remain under the NIIT threshold of $200,000 or $250,000 to avoid NIIT on other NII.

Trusts are especially vulnerable to the NIIT, even though not subject to SECA or FICA tax, because at very low taxable income ($12,150 in 2014), it applies, along with the new 39.6% federal income tax rate. There are various techniques to mitigate the NIIT for trusts. Adding a trustee who is an active participant in the business may work. Making distributions to beneficiaries who may be at a 10% or lower effective income tax brackets will reduce tax liability, perhaps with retention of the funds in subtrusts to protect the distributions from either or both the beneficiaries' control and their creditors.

The use of a limited partnership having an S Corporation general partner may offer the additional benefit of permitting step up in basis of the vast proportion of the TorB ownership upon death of a participating owner. If the activity is rental real estate, a simpler LLC structure may be adequate to avoid the 3.8% Taxes, provided that the members are real estate professionals and either satisfy the safe harbor 500 hour test of Reg. Section 1.1411-4(g)(7)(i) or satisfy separately as to the rental real estate activity the material participation test of Reg. Section 1.1411-4(g)(7)(iii).

Finally, grouping and regrouping of activities may be important in optimizing tax results.

3.8% TAXES v10-26-16 TOC

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EXHIBIT "A"

Section 1411 Imposition of tax.

(a) In general.
Except as provided in subsection (e) —

(1) Application to individuals.
In the case of an individual, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax equal to 3.8 percent of the lesser of—
(A) net investment income for such taxable year, or
(B) the excess (if any) of—
(i) the modified adjusted gross income for such taxable year, over
(ii) the threshold amount.

(2) Application to estates and trusts.
In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of—
(A) the undistributed net investment income for such taxable year, or
(B) the excess (if any) of—
(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over
(ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

(b) Threshold amount.
For purposes of this chapter, the term "threshold amount" means—
(1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000,
(2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, 1/2 of the dollar amount determined under paragraph (1), and
(3) in any other case, $200,000.

(c) Net investment income.
For purposes of this chapter—

(1) In general.
The term "net investment income" means the excess (if any) of—
(A) the sum of—
(i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),
(ii) other gross income derived from a trade or business described in paragraph (2), and
(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2), over
(B) the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

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(2) Trades and businesses to which tax applies.
A trade or business is described in this paragraph if such trade or business is—
(A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or
(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

(3) Income on investment of working capital subject to tax.
A rule similar to the rule of section 469(e)(1)(B) shall apply for purposes of this subsection.

(4) Exception for certain active interests in partnerships and S corporations.
In the case of a disposition of an interest in a partnership or S corporation—
(A) gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest, and
(B) a rule similar to the rule of subparagraph (A) shall apply to a loss from such disposition.

(5) Exception for distributions from qualified plans.
The term "net investment income" shall not include any distribution from a plan or arrangement described in section 401(a), 403(a),403(b) , 408, 408A, or 457(b).

(6) Special rule.
Net investment income shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b).

(d) Modified adjusted gross income.
For purposes of this chapter, the term "modified adjusted gross income" means adjusted gross income increased by the excess of—
(1) the amount excluded from gross income under section 911(a)(1), over
(2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (1).

(e) Nonapplication of section.
This section shall not apply to—
(1) a nonresident alien, or
(2) a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).

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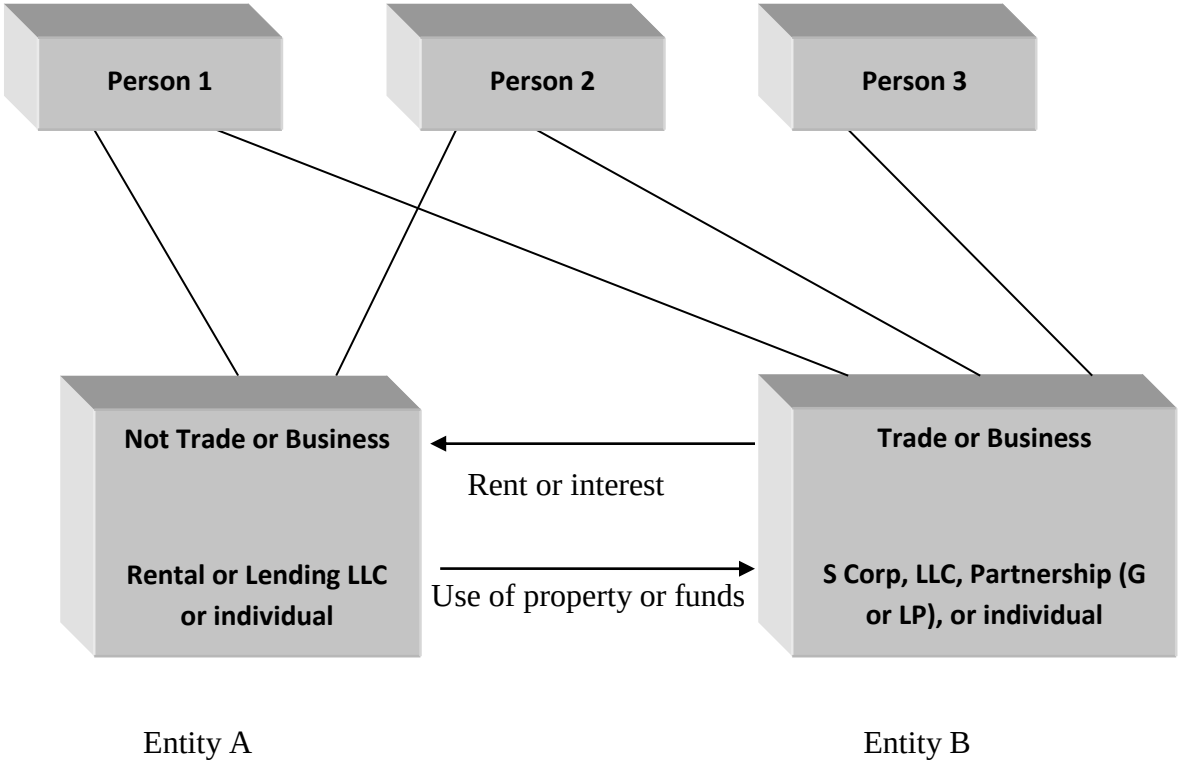
Rental or Loan Simple Structure



Notes:

- Assume Person 1 or Person 2, or both, materially participate in Entity B trade or business (500+ hours)
- Both "entities" cannot be individuals
- Interest rules may limit NIIT avoidance

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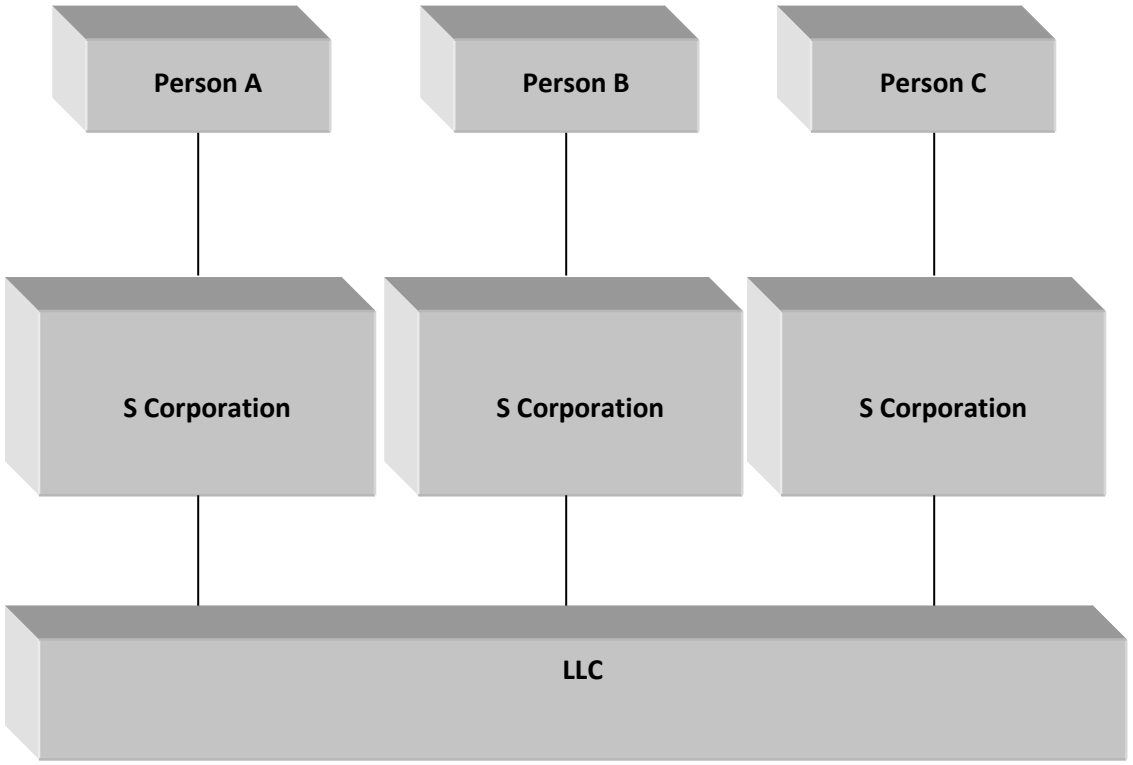
LLC with S Corporations as Blockers to Insulate



Notes:

- Assume A, B. and C materially participate (500+ hours) or significantly participate in business and receive reasonable compensation from their respective S corporations for services rendered to the corporation as a member and manager of the LLC.

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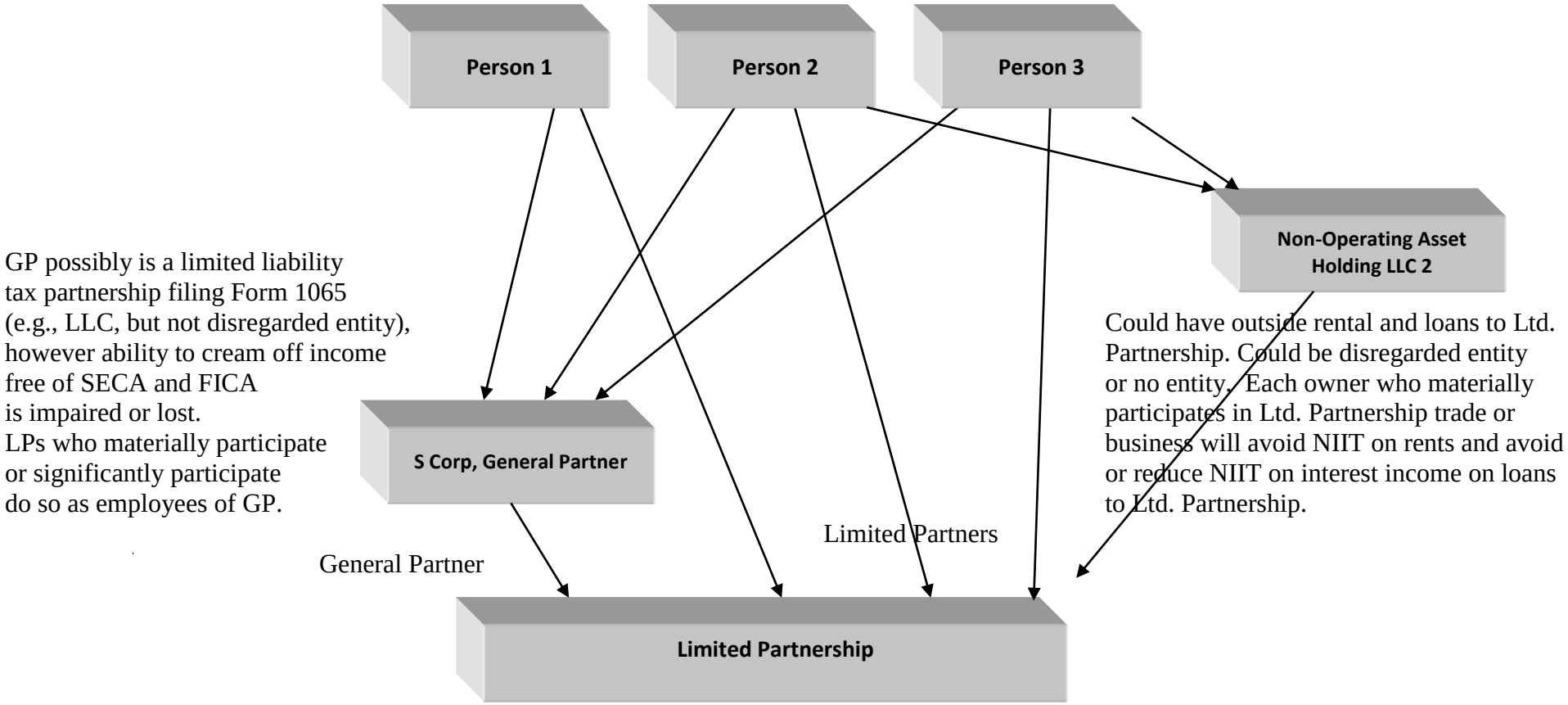
Comprehensive 3.8% Taxes Planning: LP with S Corp GP (permits basis step up of LP interest on death of LP)



The purpose of the limited partnership instead of the S Corporation alone is to permit LP interests retained by Person to obtain a step up in basis upon the death of a Person that would not occur if held in the S Corporation blocker for re-write off of basis or reduction of tax on sale of specific asset. This structure can fold up into S Corp (with rental property or notes receivable remaining outside if SECA Proposed Regs are ever finalized as written).

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