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Impact of Sec. 1411 on S Corporations and Their Shareholders

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S Corporations

One of the more significant changes to the tax landscape in recent years is the new 3.8% tax on net investment income under Sec. 1411. This tax, which was further clarified in recently finalized regulations, will affect many entities and taxpayers including S corporations and their shareholders. The following discussion outlines noteworthy aspects of these rules pertaining to S corporations and their owners.

In General

Effective for tax years beginning on or after Jan. 1, 2013, Sec. 1411 imposes a tax of 3.8% on the lesser of (1) an individual's net investment income or (2) the excess (if any) of the taxpayer's modified adjusted gross income over certain thresholds. Sec. 1411(c) defines net investment income as the sum of:

1. Gross income from interest, dividends, annuities, royalties, and rents (other than such items that are derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or trade or business of trading in financial instruments or commodities);

2. Gross income from passive activities under Sec. 469 with respect to the taxpayer or from the trade or business of trading in financial instruments or commodities; and

3. Net gain attributable to the disposition of property other than property held in a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities.

Net investment income is reduced by certain allowable expenses, as detailed in Regs. Sec. 1.1411-4(f).

Issued on Dec. 2, 2013, the final regulations under Sec. 1411 (T.D. 9644) generally apply to tax years beginning after Dec. 31, 2013. While the final regulations clarify many areas of uncertainty under the prior proposed regulations, several issues remain for S corporations and their shareholders to consider with respect to Sec. 1411.

Materially Participating vs. Passive Shareholders

One of the first determinations to be made is whether an S corporation shareholder materially participated in the business. If the shareholder materially participated in the business, the shareholder's share of the trade or business income is not treated as net investment income and is therefore not subject to the additional 3.8% tax. If the shareholder did not materially participate in the business, the shareholder's allocable portion of the business income is considered passive income and is includible as net investment income.

To materially participate in a business for a particular year, the shareholder must meet one of the following seven tests discussed in Temp. Regs. Sec. 1.469-5T(a):

1. The shareholder participated in the activity for more than 500 hours during the year;
2. The shareholder's participation in the activity constituted substantially all the participation of all individuals in the activity;
3. The shareholder participated for more than 100 hours in the activity, and the shareholder's hours were not less than those of any other participant in the activity;
4. The activity is a significant participation activity for the year, and the shareholder's aggregate participation in all significant participation activities exceeded 500 hours;
5. The shareholder materially participated in the activity for any five of the past 10 years;
6. The activity is a personal services activity where the shareholder materially participated in the activity for any three years preceding the tax year; or
7. Based on all the facts and circumstances, the shareholder participated in the activity on a regular, continuous, and substantial basis.

Grouping election: One potential tax planning opportunity to consider is an election to group activities under Sec. 469 to meet the material participation requirements. Sec. 469 allows taxpayers to group activities qualifying as an "appropriate economic unit" under Regs. Sec. 1.469-4(c). Whether activities qualify as an appropriate economic unit hinges on the facts and circumstances, including similarities in the types of trades or businesses, the extent of common control, the extent of common ownership, the proximity of the activities' geographical locations, and interdependencies between or among the activities. The final regulations allow taxpayers to regroup their activities in the first tax year beginning after Dec. 31, 2013, in which the taxpayer meets the income threshold under Sec. 1411 and has net investment income.

The regulations also allow taxpayers to adopt this provision early. Under Regs. Sec. 1.469-11(b)(3)(iv)(D), taxpayers subject to the tax can choose to regroup activities in tax years beginning in 2013. Taxpayers should examine their situation and determine whether a grouping election is appropriate. It is important to note that an election to group activities is irrevocable unless the original grouping was inappropriate or new facts and circumstances render the original grouping inappropriate.

Trusts as Shareholders

S corporations often have both individuals and qualifying trusts as shareholders. Sec. 1411 applies not only to individuals but also to trusts and estates. Under Sec. 1411(a)(2), trusts are subject to an additional 3.8% tax on the lesser of (1) the trust's undistributed net investment income or (2) the excess (if any) of the trust's adjusted gross income (AGI) over the dollar amount at which the highest tax bracket in Sec. 1(e) begins for the tax year (i.e., $11,950 for 2013 and $12,150 for 2014). Given the low threshold amounts, trustees who can distribute income to beneficiaries will want to take a close look at how any distribution would affect the beneficiary, versus the effect of retaining the funds in the trust.

Material participation of trusts: One important factor to consider is whether a qualifying trust shareholder should be treated as materially participating in the business. If the trust materially participates, its share of the trade or business income from the S corporation is not subject to the additional 3.8% tax. However, the determination of whether a trust is considered to materially participate has always been a gray area in the tax law. Although Sec. 469 does not explicitly state what constitutes material participation for a trust, the IRS has relied on the legislative

history of Sec. 469 to support its position that a trust is treated as materially participating only if the fiduciary, in his or her capacity as such, participates in the business on a regular, continuous, and substantial basis (S. Rep't No. 99-313, 99th Cong., 2d Sess. 735 (1985)).

However, a district court in *Mattie K. Carter Trust*, 256 F. Supp. 2d 536 (N.D. Tex. 2003), rejected the IRS's position that only the trustee's activities are taken into account when determining material participation with respect to the trust. Rather, the court concluded that the collective activities of the trustees and employees and agents working on behalf of the trust should be examined to determine whether the activities performed were regular, continuous, and substantial.

Regulations have never been issued in this area, and given the tendency of the IRS to look through to the fiduciary, it is imperative to look at each trust and its fiduciary and determine the fiduciary's current level of involvement (if any) in the business. The final regulations under Sec. 1411 do not address what constitutes material participation for a trust, perhaps because any guidance issued could affect both Secs. 469 and 1411. In the preamble to the final regulations, the IRS acknowledges the lack of guidance in this area, indicating that the issue is under review and may be addressed later in separate guidance.

ESBTs: Electing small business trusts (ESBTs) are also affected by Sec. 1411. An ESBT is treated as two separate trusts for income tax purposes, with one trust holding all of the S corporation stock (the S portion) and the other trust holding all the other trust assets (the non-S portion). The separate trust treatment applies for purposes of Sec. 1411—the S portion and the non-S portion separately calculate their undistributed net investment income. However, for purposes of determining the trust's AGI under Sec. 1411, the S and non-S portions are treated as one trust. Regs. Sec. 1.1411-3(c)(2) has a detailed example showing how to combine the two portions to calculate the trust's AGI, as well as other information on the ESBT Sec. 1411 calculation.

Common Shareholder–S Corp. Transactions

The proposed regulations (REG-130507-11) alerted tax practitioners to the fact that income from many common shareholder–S corporation transactions could be treated as net investment income and subject to the additional tax. The final regulations, however, did provide relief for self-rental income and self-charged interest.

Self-rental income: Self-rental income arises when a shareholder rents property to an S corporation. The property is typically owned directly by the S corporation shareholder or held inside a separate entity owned by the shareholder. Under Sec. 469, rental income is almost always considered passive income. However, to prevent taxpayers from using a self-rental arrangement to generate passive income to offset unrelated passive losses, Regs. Sec. 1.469-2(f)(6) recharacterizes as nonpassive the rental income earned from a business in which the taxpayer materially participates.

The proposed regulations under Sec. 1411 did not specifically address whether self-rental income subject to recharacterization under Sec. 469 would be treated as net investment income for purposes of Sec. 1411. The final regulations address this issue, explicitly stating that (1) income from self-rental activities is treated as derived in the ordinary course of business, and (2) the characterization of such income as nonpassive due to Regs. Sec. 1.469-2(f)(6) also applies for purposes of Sec. 1411. Consequently, self-rental income is not included in net investment income. In addition, the regulations provide that any gain or loss from the sale of the assets generating the rental income is treated as nonpassive and not subject to the additional tax.

Self-charged interest: Shareholders often have interest income from loans made to S corporations. Under the proposed regulations, if the shareholder materially participated in the business, this self-charged interest would

have been included in net investment income, because the offsetting interest expense allocable to the taxpayer from the nonpassive activity would not be a properly allocable deduction. The final regulations address this issue by including a special rule stating that self-charged interest received from a nonpassive entity is excluded from net investment income to the extent of the shareholder's allocable share of the nonpassive deduction.

> ***Example:*** Individuals *A* and *B* own S corporation *C* equally. Shareholder *A* loans *C* money and receives $1,000 of self-charged interest income during the year. For Sec. 1411 purposes, *A* can exclude $500 of the $1,000 interest income from net investment income (i.e., *A*'s allocable share of the nonpassive deduction). The remaining $500 is treated as net investment income to *A*.

Gain or Loss Attributable to the Disposition of S Corp. Stock

Although net investment income generally includes gains from the disposition of property, an exception exists for gains related to a transferor's disposition of a nonpassive interest in a partnership or an S corporation. The proposed regulations described the method a taxpayer would use to calculate this exclusion, and commentators noted these rules were complex and burdensome to taxpayers. As a result, Treasury and the IRS withdrew the proposed regulations and issued new proposed regulations along with the final regulations (Prop. Regs. Sec. 1.1411-7; REG-130843-13).

New proposed regulations: The new proposed regulations modify significantly the calculation of includible gain and make substantive changes to the information-reporting requirements. Under the new "primary method" outlined in the proposed regulations, the transferor's includible gain would be calculated as the lesser of (1) the amount of gain recognized and (2) the transferor's allocable share of net gain from a deemed sale of the entity's "Sec. 1411 property" (i.e., property that, if sold, would generate gain or loss that would be includible in net investment income). In addition, the transferor would no longer be required to provide property-by-property information (as was outlined in the previously proposed regulations) to substantiate the exclusion of gain. Instead, taxpayers would be allowed to compute the information on an activity-by-activity basis, thereby significantly reducing the compliance burden.

In addition to the primary method outlined above, the new proposed regulations would allow certain transferors to apply an "optional simplified reporting method" in situations where the gain associated with passive assets is likely to be small. This method would significantly reduce the information-sharing burden on the passthrough entity by allowing the transferor to use information from historical Forms K-1 to determine the percentage of the overall gain includible in net investment income. To qualify for the simplified method, the transferor would need to satisfy at least one of two requirements:

1. For the year of disposition and the prior two years (or the period the transferor held the interest, whichever is less), (a) the cumulative sum of the transferor's allocable share of separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers) that ordinarily would be includible in net investment income (e.g., interest income, dividend income, etc.) is 5% or less of the cumulative sum of all separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers), and (b) the total gain or loss is $5 million or less (including gains or losses from multiple dispositions as part of a plan); or

2. The total gain or loss (including gains or losses from multiple dispositions as part of a plan) is $250,000 or less (Prop. Regs. Secs. 1.1411-7(a)(2)(iii) and (c)(2)(i)).

Upon meeting either of those conditions, the taxpayer would have the option of using the simplified method, which essentially would involve applying the historic percentage outlined above to the total gain or loss recognized on

the sale. The calculated amount would be included in net investment income.

Conclusion

Sec. 1411 and the final regulations raise many issues for S corporations and their shareholders with regard to the additional 3.8% tax on net investment income. Given the nuances of Sec. 1411, a thorough review of each taxpayer's individual facts should be performed to determine any effect the new law and associated regulations will have.

EditorNotes

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