Net Investment Income Tax Regulations Affecting S Corporations

By Michael Kosnitzky and Michael Grisolia

Michael Kosnitzky and Michael Grisolia examine the use of S corporation structures to limit Net Investment Income Tax (NIIT).

On December 5, 2012, the IRS promulgated proposed regulations ("Proposed Regulations")[1] providing guidance under Code Sec. 1411. Code Sec. 1411 was created as part of the Health Care and Education Reconciliation Act of 2010 and imposes a new net investment income tax (NIIT) of 3.8 percent on individuals, estates and trusts for tax years beginning after December 31, 2012. The Proposed Regulations are generally advisory for 2013 tax years (acting as a safe harbor for taxpayers), and it is expected that a revised version will be binding for 2014 and later tax years.

The NIIT is in some sense complementary to the "Medicare" tax imposed on compensation income.[2] Nevertheless, the Proposed Regulations create or permit certain planning opportunities allowing some income to be subject to neither employment/self-employment tax nor the NIIT (both now at 3.8 percent generally, when including both the employer and employee shares of employment taxes), which taxpayers may wish to consider. This article focuses on the possible use of S corporation structures allowing taxpayers to achieve this result. It points out why S corporations are a more effective structure than other passthrough entities for limiting this tax exposure. It also briefly describes guidance under the Proposed Regulations for certain types of trusts that may be S corporation shareholders, as well as what deductions may offset net investment income (for S corporation shareholders or other taxpayers with net investment income). Taxpayers should implement any adjustments or restructurings as soon as possible, so as to be effective for 2013 tax years.

It should be noted that the binding final regulations anticipated to follow the Proposed Regulations may differ significantly from the Proposed Regulations, and in particular may preclude some or all of the planning opportunities described below if it is determined that these opportunities were unintentional and undesirable.[3]

S Corporations

Treatment of S Corporation Allocated Income and Deductions

The Proposed Regulations provide that income allocated to shareholders will be subject to the NIIT if it is any of the following:

(1) Gross income from interests, dividends and other specified types of payments ("Portfolio Income"),[4] except to the extent derived in the ordinary course of a trade or business that is not the trade or business of a trader trading in financial instruments or commodities ("Financial Trading") and is not a passive activity ("Passive" and, if it is not Passive, "Active")[5]

(2) "Other gross income" derived from a trade or business that is Financial Trading or Passive

(3) Net gain attributable to the disposition of property, except to the extent attributable to

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property held in a trade or business that is not Financial Trading or Passive[6]

(As an aside, it is also worth noting that the NIIT is imposed under Chapter 2A of Title 26 of the U.S. Code, not Chapter 1 like ordinary income taxes. Tax practitioners should review S corporation shareholder agreements and other passthrough entity operating agreements to make sure that provisions for distributing cash to cover tax obligations of the shareholders, partners, or members will cover NIIT obligations as well.)

Although the Proposed Regulations do not expressly state the point, they suggest that passthrough entities are treated under an aggregate theory—as such entities earn income, it is allocated to their shareholders and maintains the character of such income as Portfolio Income, trade or business income, or Financial Trading Income, irrespective of whether such amounts are received by a shareholder.[7] For purposes of testing whether such passthrough income is derived from a Passive or Active trade or business, the relevant trade or business is the trade or business of the passthrough entity (or its passthrough subsidiary[8]). However, whether the trade or business is Passive or Active will be determined at the individual level for each ultimate shareholder.[9] This further implies that each item of income may be tested separately—income attributable to one trade or business might be exempt from the NIIT for a given shareholder, while income attributable to another trade or business is subject to the NIIT for the same shareholder (for example, if a single S corporation operates both a Financial Trading business and an investment advisory business in which the shareholder is Active).[10]

In short, an S corporation shareholder's allocated income and the shareholder's gain from the sale of the S corporation stock will generally be exempt from the NIIT to the extent they meet the following conditions: (1) they are attributable to a trade or business of the S corporation or its passthrough subsidiary[11]; (2) that trade or business is not a Financial Trading trade or business; and (3) that trade or business is Active with respect to that shareholder.[12] These three requirements are discussed in more detail below, and then applied to the specific contexts of professional services business as well as management fees, carried interests and rental income.

The first requirement for NIIT exemption, that payments to a shareholder in respect of S corporation stock be attributable to a trade or business, is relatively straightforward. Even here, however, there is an important wrinkle to note—to the extent that the income of the trade or business is derived from Portfolio Income, Proposed Reg. §1.1411-4(a)(1)(i) will apply, rather than (a)(1)(ii) or (iii). Unlike the other clauses, (a)(1)(i) only allows an exception from the NIIT if the income is derived *in the ordinary course* of a trade or business, not just implicitly from a trade or business (as in (a)(1)(ii)) or from the disposition of property held in a trade or business (as in (a)(1)(iii)). For example, a shareholder owns an interest in an S corporation with a manufacturing trade or business. On a one-time basis, the S corporation makes a loan to a major buyer as part of an agreement related to the purchase of the S corporation's manufactured products. The interest income with respect to the loan would constitute Portfolio Income, and while it is related to the manufacturing trade or business, it is not derived in the "ordinary course" of that trade or business. Accordingly, the interest income allocated to the corporation's shareholders would be subject to the NIIT. Generally, to the extent that an S corporation's trade or business involves the receipt of Portfolio Income, any receipts not in the ordinary course will be automatically subject to the NIIT.[13] The Proposed Regulations also specifically provide that income from the investment of working capital, which might appear to qualify for exemption here, is not treated as derived in the ordinary course of a trade or business, making it subject to the NIIT.[14]

The second requirement, that the trade or business not be Financial Trading, is also defined fairly simply. Income from a trade or business is automatically subject to the NIIT if it is "[t]he trade or business of a trader trading in financial instruments … or commodities … ."[15] Financial instruments are defined broadly to include all equities, debts and derivatives thereof.[16] Commodities are defined by reference to Code Sec. 475(e)(2), which includes any actively traded commodity and any derivatives or hedges with respect thereto.[17]

Finally, the trade or business must be Active, not Passive, as to each individual shareholder (at the ultimate S corporation shareholder level) seeking exemption from the NIIT. This determination is made by reference to two existing sections of the Code: something will only be Passive, and thus not qualified for NIIT exemption, if it is both a trade or business within the meaning of Code Sec. 162 and a "passive activity" within the meaning of Code Sec. 469 and the regulations thereunder.[18] While any activity that is not a trade or business under

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Code Sec. 162 would thus not be subject to the NIIT under Proposed Reg. §1.1411-5(b), it will likely be subject to the NIIT under other provisions of the Proposed Regulations.[19] Thus, the principal question in determining whether a trade or business is Active or Passive is whether the trade or business would constitute a passive activity under Code Sec. 469 and the Treasury Regulations thereunder.

Full discussion of the passive activity rules under Code Sec. 469 is beyond the scope of this article, but the essential point is that the shareholder must "materially participate" in the conduct of the trade or business for the tax year. The material participation standard can be met in any of several ways, including (1) a total of 500 hours of participation, (2) being substantially the only participant, (3) participating for at least 100 hours as long as no other individual participates more, and (4) participating for at least 100 hours in the activity (a "significant participation" activity) and participating in all "significant participation" activities for at least 500 total hours.[20]

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Importantly, there are two major features helping taxpayers to meet this requirement: grouping rules that help taxpayers to meet this threshold and a focus on the year of disposition for treatment of net gains that means taxpayers only need to plan for the tax year of disposition.

First, the rules for grouping activities to determine whether they are Passive allow taxpayers to aggregate their participation across multiple related trades or businesses for purposes of qualifying them as Active. These grouping rules permit consolidation into a single activity if they constitute an "appropriate economic unit."[21] This is determined based on a facts-and-circumstances tests that looks to five factors: (1) similarities and differences in types of trades or businesses, (2) the extent of common control, (3) the extent of common ownership, (4) geographical location, and (5) interdependencies (*e.g.,* transactions between the activities, shared customers, shared employees or shared books and records).[22] Note that a taxpayer may consolidate activities even if they are operated under different entities, if the facts and circumstances support it.[23] Given these rules, and especially combining the grouping rules with the "significant participation" category of material participation, it may be very possible for taxpayers to meet the material participation tests by grouping activities. For example, if a taxpayer was able, based on the facts and circumstances, to consolidate all of his or her activities into five groups, and participated in each group for at least 100 hours, the taxpayer would be deemed to have materially participated in all of the activities and thus all of the income would be Active income as to that taxpayer.

In recognition of the fact that taxpayers may wish to regroup their activities in light of the Proposed Regulations and the NIIT, the Proposed Regulations provide for a one-time "fresh start" allowing taxpayers subject to the NIIT to regroup their activities in the first year that they are subject to the NIIT, although the Proposed Regulations are ambiguous about whether this fresh start is to be used during 2013 tax years or the first applicable tax year thereafter.[24]

Second, with respect to net gains on disposition, the Proposed Regulations do not appear to contemplate any "look-back" to prior tax years.[25] This creates substantial planning opportunities in advance of any anticipated disposition of assets. Most importantly, shareholders can increase their level of activity in order to reach one of the material participation thresholds for the contemplated year of a sale of a business unit. Other planning may also be possible, such as reallocating assets between trades or businesses for the year of disposition. If only certain assets will be disposed of, they can be deliberately used in a trade or business that is not Financial Trading or Passive while other assets to be retained are held in trades or businesses that would trigger NIIT liability. If the entire business will be disposed of by a stock sale, those assets with the most built-in gain should be allocated to trades or businesses that are not Financial Trading or Passive in order to maximize the portion of the overall gain exempt from the NIIT. Of course, this also creates a trap for the unwary—if a taxpayer has materially participated in previous years, but not in the year of disposition, that taxpayer would face disproportionately large NIIT exposure. However, the trap is mitigated by the rules deeming a taxpayer to materially participate based on material participation in a sufficient number of prior years.[26]

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Specific Applications

As discussed below, S corporations are uniquely qualified to take advantage of these rules governing the NIIT, potentially allowing substantial amounts of income to be paid out to individuals without being treated either as employment/self-employment income (subject to Medicare tax) or net investment income (subject to the NIIT), and thus exempt from both 3.8-percent taxes. The following subsections consider the potential use of S corporations to limit tax exposure in four contexts: professional service businesses, management fees, carried interests and rental activities.

Professional Service Businesses

One area in which such use of an S corporation structure not subject to the NIIT could benefit taxpayers is in the context of personal service businesses. Such a business is often structured as a limited liability partnership or similar entity created by state law specifically for professional services businesses. As an example, consider a partner in a law firm who was allocated $1 million in total payments from the firm. As discussed below, the IRS would generally treat the partner's entire $1 million as self-employment income subject to self-employment tax (including Medicare tax at 3.8-percent with no cap). If the partner's interest were held through a C corporation, the corporation would be subject to corporate income tax and the corporate shareholder (the indirect partner) would have to pay tax on the dividend received as well as the NIIT; if all (or perhaps a portion) of the amount were instead taken out as a salary, it would be deductible to the corporation (thus reducing the corporate income tax) but subject to ordinary income tax as well as employment taxes. Under current law, these approaches would result in aggregate tax rates of 50.47 percent and 43.4 percent, respectively.[27] However, if the partner's interest were held through an S corporation, the payments could be divided between reasonable compensation and dividends in excess of reasonable compensation. If the facts and circumstances justified reasonable compensation for services of only $250,000 (*e.g.,* the firm is substantially leveraged and so most of the partner's receipts are attributable to the services of other individuals), then the remaining $750,000 would be exempt from self-employment tax.[28] Because legal practice would constitute a trade or business that is not Financial Trading and in which the partner materially participates (and thus an Active trade or business), the remaining $750,000 would also be exempt from the NIIT. Unlike the NIIT, self-employment tax is not imposed on a look-through basis—a shareholder's sale of partnership interests or S corporation stock is expressly excluded from self-employment tax, as the entity's sale of any assets other than inventory[29]—so the "gap" between self-employment tax and the NIIT can be even larger upon a disposition of the business.[30] Although many of the authorities underlying the use of S corporations for self-employment tax planning have existed for years, it is notable that the Proposed Regulations appear to deliberately not "close the gap" and impose the NIIT on this S corporation income in excess of reasonable compensation. This should renew interest in this approach compared to other methods of extracting excess value that may trigger the NIIT.

Management Fees

Managers of investment funds typically receive two forms of compensation: a management fee based on the value of the assets under management (traditionally two percent) and a carried interest in the profits of the investments (traditionally 20 percent). Avoiding both the NIIT and self-employment tax on the management fees should be fairly straightforward for a private equity fund. It does not matter that the activities of the fund itself, or even the activities of its investees, may not qualify as Active, non–Financial Trading trades or businesses,[31] as the source of the management-fee income is the provision of investment advisory services by the investment advisor entity. In their capacity as recipients of management fees, the managers are not trading in financial instruments, but are providing investment advice to others, a form of personal services. Thus, these fees would not constitute Financial Trading income. They are derived from a trade or business which is clearly Active as to the individual managers, and the fee income would be eligible for NIIT exemption. This argument would apply equally to hedge fund managers except that, as other commentators have noted,[32] the preamble to the Proposed Regulations indicates that the government views portfolio management in connection with Financial Trading as constituting Financial Trading itself, subjecting the related income to the NIIT.[33] While the preamble is not binding on taxpayers, it is both indicative and likely to be followed by binding language in the final regulations. The basic idea for the structure would be the same as for a professional

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service business—either the managers collectively form an S corporation to pay out their fees, or each forms an individual S corporation for his or her fee. As the fees result in allocations to the managers, those allocations would be exempt from the NIIT (and from self-employment tax, to the extent of allocations in excess of reasonable compensation) for the same reasons outlined above.

Carried Interests

Carried interests, which in most cases represent the bulk of fund managers' income, may also be able to qualify for NIIT exemption. However, there are several significant issues that arise in this context that would not be obstacles in the context of professional services or management services. First, at the level of the fund, carried interests represent an investment interest in another company (analogous to a stock option), which would generally result in Financial Trading Income subject to the NIIT.[34] In order for the trades or businesses of the operating companies (rather than the fund's activities) to be the relevant level of inquiry, the operating companies would have to be structured as passthrough entities, which may not always be feasible. If the operating companies are C corporations, the "look-through" will stop at the level of the fund. Only by looking through to the operating company level can a non–Financial Trading trade or business be identified. Secondly, since the applicable trade or business being tested must be that of the passthrough operating–company issuers themselves, not the fund's activities of buying and selling investments in them, in order to avoid the NIIT, it may be difficult for fund managers to qualify as Active. In order for the income to qualify as Active, the managers must take the position that they materially participate in the underlying trades or businesses of the operating companies. A third difficulty is that much of the carried interest income of a typical fund will arise from the disposition of interests in companies upon a liquidity event, which means that the income will be proportionally subject to the NIIT based on the built-in gain of assets held in trades and businesses exempt from the NIIT and the built-in gain of the sold company's other assets. It may be difficult to support the position that some of the operating company's substantially appreciated assets are held in its trade or business (particularly intangible assets[35]), which would result in a corresponding substantial portion of the overall gain being subject to the NIIT.

Nevertheless, the Proposed Regulations create or permit certain planning opportunities allowing some income to be subject to neither employment/ self-employment tax nor the NIIT (both now at 3.8 percent generally, when including both the employer and employee shares of employment taxes), which taxpayers may wish to consider.

The situation in which fund managers would be most likely to be able to avoid both the Financial Trading and Passive income impediments described above would be as a manager of a small or highly specialized private equity fund that invests in companies structured as passthrough entities. There would be actual operating businesses rather than Financial Trading underlying the income distributed to the managers, thus avoiding the NIIT trigger for Financial Trading. Furthermore, to the extent that a manager participates in the actual management of the operating businesses (*e.g.,* by board membership and oversight[36]), the manager may be able to reach a sufficient level of activity to constitute material participation, thus avoiding the NIIT trigger for Passive activities. The material participation requirement will likely to be easier to meet for a small or specialized fund because the managers of a small fund will generally spend more time on each individual investment and the investments of a specialized fund are more likely to qualify for grouping. Even in this context, however, the potential difficulty with attributing appreciated assets to the operating company's trade or business (discussed at the end of the preceding paragraph) may remain.

Some commentators have identified an alternative theory under which private equity fund managers could more easily seek exemption from the NIIT.[37] Under this approach, taxpayers treat the investment management activities of the fund itself as the applicable trade or business (such that portfolio companies/investees need not be passthrough entities and the individual managers need only materially participate at the fund level). This approach is based on the theory that, in addition to investors, traders

and dealers, some limited case law recognizes a fourth category of persons who profit from securities: promoters/developers. Promotion/development activity constitutes a trade or business and does not constitute Financial Trading, meaning that any Active individual would be exempt from the NIIT on related income. However, the legal argument for treating the activities of a private equity fund as a trade or business is a difficult one, with authorities mixed.[38] In addition, even if successful, this approach would avoid the NIIT only at the cost of potentially converting capital gain into ordinary income, increasing overall tax liability.

Rental Activities

Income from rental activities is Portfolio Income, and therefore *per se* subject to the NIIT unless it is derived in the ordinary course of a trade or business that is not Passive or Financial Trading. (Even if the rental activities are not technically "passive activities" under Code Sec. 469 and related regulations because there is no trade or business, the income from those activities will still be subject to the NIIT.) However, if it is possible to qualify rental income as exempt from the NIIT, avoiding self-employment tax on that income will be relatively simple—rental income from real property and related personal property is excluded from self-employment tax by default, with exceptions for rental income received by a dealer in real property or if substantial services are provided in connection with the property. While it may be difficult for a taxpayer to be Active in a rental trade or business without that business performing "substantial services,"[39] self-employment tax does not look through a passthrough entity such as an S corporation.[40] Thus, the rentals may include substantial services, even substantial services provided by the shareholder, and the S corporation shareholder will only be subject to self-employment or payroll tax to the extent of "reasonable compensation."

The more difficult question is how to qualify rental income as derived in the ordinary course of a trade or business that is not Passive and not Financial Trading. The government has expressly declined to define either "ordinary course"[41] or what level of real-estate rental activity would constitute a "trade or business,"[42] although it has offered limited guidance in both areas.[43] Accordingly, taxpayers should be mindful of the facts and circumstances and carefully compare them with what limited guidance is available. Once it is established that the rental income was derived in the ordinary course of a rental trade or business, it is still necessary that the income be neither Passive nor Financial Trading in order to qualify for NIIT exemption. The requirement to be Active rather than Passive may also be difficult to meet, but is at least a clear black-and-white standard based on the material participation requirements discussed above, unlike the "ordinary course" and "trade or business" requirements. Finally, the Financial Trading requirement should be the simplest hurdle to clear, since rental income is necessarily derived from renting assets, rather than trading them. If all of these requirements are met, then rental income allocated to a taxpayer by an S corporation can be exempt from both the NIIT and (except for reasonable compensation) self-employment tax.

> Taxpayers should implement any adjustments or restructurings as soon as possible, so as to be effective for 2013 tax years.

Electing S Corporation Status

An S corporation is, fundamentally, nothing more than an ordinary state-law corporation that has elected to be taxed under Subchapter S of the Code (which provides generally for passthrough taxation) instead of subchapter C (the default treatment for corporations, with a separate entity-level tax). Not all corporations are eligible to make the "S election" however. Notably, the corporation must meet corporate, shareholder and capitalization requirements, each of which is discussed below.

The corporate requirements restrict certain types of corporations from becoming S corporations because they are *per se* ineligible for S corporation status. First, an S corporation must be a domestic corporation,[44] which means that it must not be foreign or a noncorporate entity. (Note, however, that a domestic noncorporate entity may make an S corporation election if has elected to be treated as an association taxed as a corporation.[45]) In addition, the electing corporation must not be an "ineligible corporation," defined to include (1) financial institutions that use the reserve method of accounting under Code Sec. 585, (2) insurance companies subject to tax under Subchapter L, (3) corporations subject to a Code Sec. 936 "possessions corporations" election, and (4) DISCs and former DISCs.[46]

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S corporations must also meet strict shareholder requirements. There may be no more than 100 shareholders,[47] and each shareholder must be an individual, estate, eligible trust or eligible tax-exempt entity.[48] In addition, no nonresident alien may be a shareholder.[49]

Finally, S corporations must meet an unusual capitalization requirement: they may only have one class of stock.[50] A variety of difficult issues can arise as to whether all of the equity interests are consistent with the single class of stock requirement. This is particularly so in the case of an entity that has elected to be taxed as a corporation (such as a partnership with both limited and general partners).[51] Specific guidance exists regarding several of the most common issues, such as bank director stock,[52] options,[53] and incentive plans.[54] As a general rule, however, all shares are deemed to constitute a single class of stock if they have "identical rights to distribution and liquidation proceeds" even though their voting rights may differ.[55]

If all of these requirements are met, a corporation may convert to an S corporation by an election on Form 2553, with the unanimous consent of the shareholders, per Code Sec. 1362. However, significant potential adverse tax consequences can be triggered by such a conversion, such as recapture of LIFO[56] benefits under Code Sec. 1363(d). If the entity seeking S corporation status is not already a corporation, it may file Form 8832, electing to be taxed as a corporation rather than as a partnership,[57] or it may simply skip the Form 8832 and file the Form 2553 with the same result.[58] Again, however, it must first determine that it meets all of the requirements above.

Please note that election rules and tax treatment for S corporations under state laws may vary (such as requiring a separate state-level election, as in New York,[59] or simply not allowing passthrough tax treatment for S corporations at all, as in New Hampshire[60]). A full consideration of state law issues is beyond the scope of this article, but should be conducted with respect to relevant states before taking any action.

Advantages of S Corporations over Partnerships

The above analysis and potential applications would in theory apply equivalently to any form of passthrough entity, since all are treated equally under the Proposed Regulations. However, limited partnerships and other entities taxed as partnerships under Subchapter K of the Code face an additional obstacle in minimizing tax exposure: a higher propensity for payments to active partners to be subject to self-employment tax. While limited partners are generally exempt from self-employment taxation on payments other than compensation for services,[61] the IRS and courts have pushed back on the application of this exception to "limited partners" who participate actively, such as in limited liability partnerships and limited liability companies. For example, in *Renkemeyer, Campbell & Weaver, LLP*, the three partners in a law firm operating as a limited liability partnership were determined to be liable for self-employment tax with respect to their entire distributive shares of the partnership's income.[62] Similar results have applied to members of limited liability companies.[63]

In addition to these cases, proposed regulations related to the limited partner exception also exist limiting the availability of the limited partner exception. These proposed regulations provide that a taxpayer will not be treated as a limited partner (and thus will be subject to self-employment tax) if the taxpayer has liability for the entity's debts by reason of being a partner, has the authority to bind the entity to contracts, or participates for more than 500 hours per year in the trade or business. Furthermore, if the entity is involved in certain professional fields such as law, providing more than *de minimis* services precludes limited partner treatment.[64] There are also some complexities regarding the application of self-employment tax to a taxpayer who owns both general partner and limited partner interests in a single partnership.[65]

By contrast, S corporations not only lack these adverse precedents, but in fact have favorable precedents supporting taxpayers' assertions that only part of their income from a trade or business in which they are Active constitutes employment income. For example, in *David E. Watson, P.C.*, although the IRS prevailed, it only asserted that approximately half of the S corporation's income constituted reasonable compensation to its sole shareholder, in a situation in which the S corporation's only source of income was its interest in an accounting firm for which its sole shareholder worked (and which interest it had received from its sole shareholder).[66] (In an analogous partnership case like *Renkemeyer*,[67] the IRS would have argued that the entire amount paid to the sole owner constituted compensation.) The IRS has even provided guidance on facts and circumstances relevant in determining what fraction of an S corporation's earnings should be considered reasonable compensation.[68]

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Thus, depending on the facts and circumstances, an S corporation shareholder who actively participates in the S corporation's business may be able to justify treating a portion of his or her S corporation receipts as exempt from self-employment tax. To the extent that these amounts also meet the conditions described previously, these amounts will also be exempt from the NIIT. As an illustration of this advantage, in order to avoid both taxes, a limited partner in a partnership would have to "materially participate" (so as to be Active) and yet also work for less than 500 hours (so as to avoid self-employment tax as a limited partner under the Code Sec. 1402 proposed regulations), a difficult needle to thread. For professional service partnerships, where any participation more than a *de minimis* level triggers self-employment tax, the needle is essentially impossible to thread. However, for S corporations the IRS has permitted a much wider "space" between the Medicare tax and the NIIT, allowing for the possibility of income being subject to neither tax.[69]

Another advantage of S corporations is that limited partners are restricted to only using three of the seven "material participation" tests to qualify as Active, unlike S corporation shareholders. A limited partner may only qualify by (1) participating for 500 hours, (2) materially participating for five of the 10 preceding years, or (3) materially participating in a personal service activity for any three preceding years.[70]

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Treatment of QSSTs and ESBTs

Generally, only certain types of trusts may be shareholders of S corporations.[71] Two of these types, qualified subchapter S trusts (QSSTs)[72] and electing small business trusts (ESBTs),[73] are the subject of specific discussion or rules in the Proposed Regulations. (Other types of trusts and estates, such as charitable remainder trusts, are also discussed in the Proposed Regulations,[74] but this article focuses on S corporation issues.)

QSSTs

A QSST is a trust that meets certain requirements under Code Sec. 1361(d)(3) allowing the QSST's beneficiary to make an election to have the QSST treated as a permissible S corporation shareholder with respect to any S corporation stock it owns.[75] The existing Regulations reconciling the QSST rules with the grantor trust rules generally provide that the income beneficiaries of the QSST are treated as the owners, for purposes of Code Sec. 678, of the S corporation shares subject to the QSST election.[76] However, they further provide that the QSST, and not the income beneficiary, will be treated as the owner, and be subject to the income tax consequences, of a disposition of the S corporation stock by the QSST.[77] Thus, there is ambiguity about whether NIIT triggered by a disposition of S corporation stock by a QSST should be recognized by the QSST or the income beneficiary. The comments to the Proposed Regulations acknowledge that the regulations do not address whether special coordinating rules are needed to address the tax treatment of a disposition of S corporation shares held in a QSST, and the public is invited to comment on this question.[78]

ESBTs

Another form of trust permitted to own shares of an S corporation is an ESBT. Unlike QSSTs and other permitted shareholders, an ESBT may have multiple beneficiaries, as long as they each meet certain requirements and the trustee elects ESBT treatment.[79] ESBTs are subject to a distinct tax structure under which the portion of an ESBT consisting of S corporation stock is treated as a separate trust taxed at the trust level.[80] The Proposed Regulations provide that ESBTs will be taxed the same way for NIIT purposes, calculating undistributed net investment income separately for the S corporation holdings and other holdings, and only then combining these amounts to determine the ESBT's undistributed net investment income.[81] However, all of the ESBT's adjusted gross income, whether or not attributable to S corporation stock, will be aggregated for purposes of determining whether its income exceeds the minimum threshold level of adjusted gross income at which the NIIT applies.[82] This prevents an ESBT from having a tax advantage over other trusts subject to the NIIT by effectively doubling its threshold amount, which would be the case if the threshold were determined separately for S corporation and non–S corporation holdings.

Deductions from NIIT

In addition to what would constitute income subject to the NIIT, another major open question was what deductions would be allowed to reduce the amount of income subject to the NIIT. The Proposed

Regulations have provided some guidance in this area as well.

Generally

Generally, the Proposed Regulations state that only certain "properly allocable deductions" may be taken into account in determining net investment income, which are enumerated.[83]

The following so-called "above-the-line" deductions[84] are permitted:

- Deductions allocable to rents and royalties subject to the NIIT
- Deductions allocable to income from a trade or business that is Financial Trading or Passive
- Deductions for penalties on early withdrawal of savings[85]

The following itemized/"below-the-line" deductions may be taken into account:

- Investment interest allowed under Code Sec. 163(d)(1)
- Investment expenses under Code Sec. 163(d)(4)(C)
- State, local and foreign income taxes, to the extent imposed on income subject to the NIIT[86]

To the extent that any itemized deductions are limited for purposes of the income tax, they are also ratably limited for purposes of the NIIT.[87] (For example, X is a shareholder in an S corporation. X is allocated $5,000 of deductions for income tax purposes. However, only $3,000 of these deductions also apply for NIIT purposes. In addition, because of the application of Code Secs. 67 and 68, X is only able to use $2,500, or half, of the $5,000 in itemized deductions for income tax purposes. Accordingly, for NIIT purposes, X is also permitted to use only half, or $1,500, of the deductions applicable to the NIIT.) In addition, net operating loss carryovers and carrybacks are expressly prohibited from offsetting net investment income,[88] as are losses.[89] Notably, the Proposed Regulations do not prohibit suspended or carried-over deductions from applying to reduce NIIT even if those deductions originally arose in a year prior to when the NIIT is first imposed.[90]

Net Gain on Dispositions

In addition to these general deductions permitted to reduce income subject to the NIIT, certain deductions are built into the calculation of "net gain" on dispositions, which (as discussed earlier in this article) is subject to the NIIT except to the extent attributable to property used in a trade or business that is not Financial Trading or Passive. Although the Proposed Regulations are not explicit, it seems that the IRS intends that net losses from one disposition may offset net gains from another disposition, or even other nondisposition income subject to the NIIT, if they occur in the same tax year (or otherwise, to the extent capital losses may be carried over generally).[91] Notably, losses described in Code Sec. 165 may be deducted (unlike in the general case above), including losses attributable to casualty, theft and abandonment or other worthlessness, although they may not reduce net gain below zero.[92] The rules under Subchapter O of the Code (Code Secs. 1000 to 1092) and the regulations thereunder, governing determination of gain and loss on dispositions for income tax purposes, apply for the NIIT as well.[93] Thus, for example, nonrecognition of a like-kind exchange would apply for NIIT purposes.[94] Another noteworthy example is qualified small business stock under Code Sec. 1202. Gain from a qualified disposition of such stock is simply excluded from gross income.[95] Accordingly, such gain is entirely exempt from the NIIT.[96]

Persons engaged in Financial Trading businesses may find that their ability to use losses is severely limited because losses can only be used to offset net gain on disposition. Any income derived from a Financial Trading trade or business is treated as Portfolio Income or "other gross income," not net gain on disposition.[97] Because such income cannot be offset by losses, the NIIT is effectively a tax on gross income for any Financial Trading trade or business.

Endnotes

1. *Net Investment Income Tax,* 77 FR 234 (Dec. 5, 2012), at 72612–72652.
2. For example, self-employment income is specifically exempted from the NIIT. Proposed Reg. §1.1411-9(a).
3. For example, the fact that a disposition of assets does not look back across the entire period of ownership in determining whether the net gain on disposition is subject to the NIIT, described further below, may simply be an oversight.
4. The other specified categories are annuities, royalties, rents, substitute interest payments, and substitute dividend payments.
5. As discussed below, whether a trade or business falls into these categories is determined under Proposed Reg. §1.1411-5.
6. Proposed Reg. §1.1411-4(a)(1). Notably, the Proposed Regulations do not specify a timeframe over which the property must have been held in a qualifying trade or business, and the examples suggest that one merely looks to the tax year of disposition. *See, e.g.,* Proposed Reg. §§1.1411-4(d)(3)(ii)(C) and 1.1411-7(e), Example 8. (This contrasts with the application of the passive activity rules to dispositions of property for purposes of loss limitations. *See, e.g.,* Reg. §1.469-2(c)(2)(iii)(A).) This creates substantial

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planning opportunities, as discussed below.

[7] *See* Proposed Reg. §1.1411-4(b)(3), Examples 1, 2 and 3. Each of the examples applying the rules for Portfolio Income involves the income being one of the specified types at the passthrough entity level. None of them provide that the funds were actually distributed by the passthrough entity, only that income was allocated among the equity owners. *See also* Proposed Reg. §1.1411-4(b)(2) (regarding Financial Trading income being determined at the level of the operating business).

[8] The Proposed Regulations contemplate multiple passthrough entities. The entity from which the income originates is the relevant one for determining whether the NIIT applies. *See* Proposed Reg. §1.1411-4(b)(3), Example 1.

[9] Proposed Reg. §1.1411-4(b)(2). Intuitively, a trade or business may be Passive for some shareholders and Active for others, but whether or not it is Financial Trading will be the same for all shareholders.

[10] Passthrough entities with multiple sources of income will presumably need to provide breakdowns of income on their Schedule K-1s, indicating which income is *per se* subject to the NIIT and which income is exempt to the extent that the shareholder is Active. However, one unanswered question is how a shareholder's compensation income is allocated between such multiple sources. For example, suppose that an S corporation has two trades or businesses, each of which initially gives rise to $50 in income. The sole shareholder is Active with respect to both businesses, but one business is Financial Trading and therefore $50 of the total $100 is subject to NIIT. If, however, the sole shareholder takes out $50 as a salary, will the salary be split such that each business is deemed to have $25 of income, or may the shareholder take the position that the $50 salary is attributable exclusively to the Financial Trading business (which is subject to 3.8-percent tax either way)? The salary may also be allocated based on time spent in each trade or business or on some other basis. This may be an area for further administrative guidance.

[11] Although "other gross income" that is not derived from a trade or business would technically not be subject to the NIIT under category (2), it is highly likely that this type of income that is not part of a trade or business will be Portfolio Income, such that the trade or business requirement will nevertheless be necessary to avoid the NIIT. Note also that an "ordinary course" requirement may further narrow the "trade or business" gate, as discussed further below.

[12] Although Proposed Reg. §1.1411-4(d)(ii)(b)(1) provides that dispositions of equity interests in passthrough entities are generally not deemed to be attributable to a trade or business, which would make them subject to the NIIT in their entirety, Proposed Reg. §1.1411-7 provides rules for allocating the gain on a shareholder's disposition to the various properties of the S corporation based on a deemed liquidation for fair market value, with the portion of the disposing shareholder's net gain allocable to properties held in an Active, non–Financial Trading trade or business exempt from the NIIT. (For example, X, an S corporation solely owned by S, has two trades or businesses, A and B, neither of which is Financial Trading. The built-in net gain on the assets of A is $30,000 and on B is $10,000. If shareholder S sells all of her X stock, and S is Active as to A but Passive as to B, then $30,000 of S's gain on the disposition of the X stock will be exempt from the NIIT.) The calculation is based solely on the basis and fair market value of the passthrough entity's properties, not its liabilities. Thus, the same basic requirements ultimately apply to gains on disposition as to distributions. Note, however, that where there is a disparity between inside and outside basis (the shareholder's basis in the S corporation stock is not equal to the shareholder's ratable portion of the S corporation's basis in its assets), results may differ. In particular, where inside basis is greater than outside basis, the shareholder may be subject to the NIIT even though all of the S corporation's assets are held in an Active, non–Financial Trading business (and, conversely, where inside basis is less, a shareholder may avoid the NIIT even where some of the S corporation's assets are held in a Passive or Financial Trading business, or not in a trade or business at all). (To follow on the preceding example, S will be allowed $30,000 of NIIT-free gain regardless of her outside basis in the X stock, and thus her gain on the sale. If X's gain on the stock sale is $30,000 or less, it will be entirely NIIT free. Contrarily, if S has a very low basis and realizes $100,000 of gain, there will still be only $30,000 of NIIT-free gain.) Proposed Reg. §1.1411-7(e), Examples 2 and 3.

[13] The Proposed Regulations offer a bank as an example of an institution that receives interest income in the ordinary course of its trade or business. *See* Proposed Reg. §1.1411-4(b)(3), Example 3.

[14] Proposed Reg. §1.1411-6(a).

[15] Proposed Reg. §1.1411-5(a)(2).

[16] Proposed Reg. §1.1411-5(c)(1).

[17] Proposed Reg. §1.1411-5(c)(2).

[18] Proposed Reg. §1.1411-5(b)(1).

[19] Technically, income that is neither net gain from disposition of an asset nor Portfolio Income would be exempt from the NIIT if it is not derived in a trade or business. For example, certain activities that are deemed passive activities for purposes of the passive activity rules under Code Sec. 469 do not constitute trades or businesses under Code Sec. 162, such as start-up/research activities and rental activities. Code Sec. 469(c)(2) and (c)(5); Reg. §§1.469-4(b)(1)(ii) and (iii). However, any such nontrade or business passive activity income would likely constitute Portfolio Income or net gain attributable to the disposition of property. Passive rental activities would constitute Portfolio Income, and start-up/research activities generally do not lead to substantial revenue without further activity that would give rise to a trade or business. Gambling winnings (for a nonprofessional gambler) are one example of the few possible types of income that may avoid the NIIT without being a trade or business. However, such exceptions would be few, so the point that a trade or business is necessary for NIIT exemption remains generally true.

[20] Reg. §1.469-5T(a). The other ways to qualify are: material participation for five of the ten preceding tax years, material participation in a personal service activity for any three preceding years, and material participation in operations and/or management shown by the facts and circumstances. *Id.*

[21] Reg. §1.469-4(c)(1).

[22] Reg. §1.469-4(c)(2).

[23] *See* Reg. §1.469-4(c)(3), Example 2.

[24] Proposed Reg. §1.469-4(b)(3)(iv). Procedures for reporting a regrouping are provided by Rev. Proc. 2010-13, IRB 2010-4, 329.

[25] *Supra* note 6.

[26] *Supra* note 20.

[27] In the former approach, income would be subject to a 35-percent corporate income tax, and then the remainder would be subject to a 20-percent dividend tax and the 3.8-percent NIIT. In the latter approach, the income would be subject to zero corporate income tax, but a 39.6-percent personal income tax plus the 1.45-percent tax for the employer's portion of the Medicare tax and the 2.35-percent employee's portion of the Medicare tax. In each case, it is assumed that all income is taxed at the highest bracket and without consideration of Social Security taxes.

[28] The C corporation or S corporation itself would not be subject to self-employment tax because the tax only applies to individuals. Code Sec. 1401(a) and (b).

[29] Code Sec. 1402(a)(3)(A) and (C).

[30] Other types of income are also excluded from self-employment tax, such as rental income from real property and related personal property, unless the rental income is received by a dealer in real property or substantial services are provided in connection with the property. Reg. §1.1402(a)-4(c)(2). However, rental income is one of the categories of Portfolio Income, which is automatically subject to the NIIT

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unless it is derived in the ordinary course of an Active trade or business that is not Financial Trading. (That is, even if the rental activity is not a "trade or business" and thus cannot technically be Passive under Code Sec. 469 and the related regulations, the rental income will still be subject to the NIIT.) It is difficult to see how there could be an Active trade or business without providing "substantial services" that would trigger self-employment tax. A senior IRS employee has in fact expressly indicated that there will likely be no definition of what constitutes a real estate rental trade or business for NIIT purposes. *ABA Meeting: IRS Reluctant to Define Rental Trade or Business,* 2013 TNT 18-11 (Jan. 28, 2013).

[31] In fact, the investment activities of the fund will likely not qualify as a trade or business at all under the Code Sec. 469 regulations.

[32] *Can Fund Managers Escape the New Medicare Tax?* 2013 TNT 37-1 (Feb. 25, 2013).

[33] *Net Investment Income Tax, supra* note 1, at 72613.

[34] Although the manager may well materially participate in the activities of the Fund, those activities, even in the unlikely event they were to rise to the level of a trade or business, would consist of Financial Trading (buying and selling investments in operating companies), and Financial Trading income is always subject to the NIIT, even if it passes the material participation test and is Active income.

[35] Supporting the treatment of intangibles as being held in a trade or business may require significant factual development or even a private letter ruling to achieve comfort. *See, e.g.,* LTR 200825009 (June 20, 2008). However, the Proposed Regulations specify that goodwill will be treated as held in the entity's trades or business, allocated among them based on the relative fair market value of property other than cash held in those trades or businesses. Proposed Reg. §1.1411-7(c)(5)(ii)(B). This may be an area for further administrative guidance with respect to other intangibles.

[36] There are limits on what activities may count towards material participation (and thus being Active). Importantly, work done in the individual's capacity as an investor is only counted if the individual is "directly involved in the day-to-day management or operations of the activity." In addition, work that is "not of a type customarily done by an owner" is not counted if one of the principal purposes of the work is to avoid the disallowance of any loss or credit under Code Sec. 469. Reg. §1.469-5T(f)(2). However, a principal purpose of avoiding the NIIT is not mentioned, so the first restriction is the main concern for purposes of NIIT planning.

[37] *Can Fund Managers Escape the New Medicare Tax, supra* note 32.

[38] *Compare T.A. Dagres,* 136 TC 263, Dec. 58,581 (2011); *Sun Capital Partners III LP v. New England Teamsters,* DC-MA, Civ. Mo. 10-10921-DPW (Oct. 18, 2012).

[39] *Supra* note 30.

[40] *See generally* Code Sec. 1402(a) (taxing direct rental income and passthrough allocations).

[41] *Net Investment Income Tax, supra* note 1, at 72619.

[42] *ABA Meeting: IRS Reluctant to Define Rental Trade or Business, supra* note 30.

[43] The comments to the Proposed Regulations suggest looking to cases such as *T.B. Lilly,* SCt, 52-1 USTC ¶9231, 343 US 90, 93 (1953), and regulations such as Reg. §1.469-2T(c)(3)(ii) for guidance on the meaning of "ordinary course." *Net Investment Income Tax, supra* note 1, at 72619. As to the standard for a rental trade or business, a government representative has indicated that it is a "rough" standard and that the operation of a single rental building may or may not be sufficient, depending on the facts and circumstances. This representative also advised that some tax practitioners may be too quickly concluding that clients' rental activities rise to the level of a trade or business. *Id.*

[44] Code Sec. 1361(b)(1).

[45] LTR 9116011 (Jan. 17, 1991).

[46] Code Sec. 1361(b)(2).

[47] Code Sec. 1361(b)(1)(A).

[48] Code Sec. 1361(b)(1)(B). Code Sec. 1361(c)(2) and (c)(6) provide which trusts and tax-exempt entities are eligible, respectively.

[49] Code Sec. 1361(b)(1)(C).

[50] Code Sec. 1361(b)(1)(D).

[51] The IRS has identified the limited partnership question as a topic for extensive study. Rev. Proc. 2002-3, IRB 2002-1, 117, at 125.

[52] Reg. §1.1361-1(f)(1).

[53] Reg. §1.1361-1(l)(4)(iii).

[54] Reg. §1.1361-1(b)(4).

[55] Reg. §1.1361-1(l)(1).

[56] "Last In, First Out" inventory accounting for determining cost basis of sales revenue.

[57] The election to be taxed as a corporation is provided by Reg. §301.7701-3(a).

[58] *See* Instructions for Form 2553 (Rev. Dec. 2007).

[59] N.Y. Tax. Law §660(a).

[60] N.H. Rev. Stat. §77-A:1(IIIb).

[61] Code Sec. 1402(a)(13).

[62] *Renkemeyer, Campbell & Weaver, LLP,* 136 TC 13 (Feb. 9, 2011).

[63] *See, e.g., L.A. Howell,* 104 TCM 519, Dec. 59,240(M), TC Memo. 2012-303 (2012).

[64] Proposed Reg. §1402(a)-2(h). The specified professional fields are health, law, engineering, architecture, accounting, actuarial science and consulting.

[65] Proposed regulations promulgated in 1997 provided that such a taxpayer would be allowed to bifurcate the general and limited partner interests, subject to certain restrictions beyond the scope of this article. Proposed Reg. §1.1402(a)-2(h)(3).

[66] *David E. Watson, P.C.,* CA-8, 668 F3d 1008 (2012).

[67] *Supra* note 62.

[68] FS-2008-25, *Wage Compensation for S Corporation Officers* (Aug. 2008).

[69] Note that proposed legislation as of January 2013, H.R. 348, would broaden the applicability of the self-employment tax to S corporation income if enacted, almost completely eliminating this gap and the associated planning opportunities.

[70] Reg. §1.469-5T(e)(2). Note, however, that in *S.A. Gregg,* DC-OR, 2001-1 USTC ¶50,169, 186 FSupp2d 1123, the court determined that the limited partnership test is obsolete when applied to limited liability company members, because the limited liability statutes create a new type of business entity that is materially distinguishable from a limited partnership and that is designed to permit active involvement by members with limited liability in the management of the business. The court thus determined that in the absence of any regulation asserting that a limited liability company members should be treated as limited partners of a limited partnership, the government's conclusion that the taxpayer was a limited partner is inappropriate and the restrictions of Reg. §1.1469-5T(e)(2) should not apply.

[71] Code Sec. 1361(b)(1)(B) and (c)(2).

[72] Code Sec. 1361(d).

[73] Code Sec. 1361(c)(2)(A)(v).

[74] *E.g.,* Proposed Reg. §1.1411-3(c)(2).

[75] A separate election must be made with respect to each S corporation in which the QSST holds stock. Code Sec. 1361(d)(2)(B)(i).

[76] Reg. §1.1361-1(j)(8).

[77] *Id.*

[78] *Net Investment Income Tax, supra* note 1, at 72628. The Proposed Regulations contain a reserved placeholder for such a provision. Proposed Reg. §1.1411-7(b)(2).

[79] Code Sec. 1361(e).

[80] Code Sec. 641(c).

[81] Proposed Reg. §1.1411-3(c)(1)(ii)(A). Note that the NIIT only applies to a trust or estate to the extent of undistributed net investment income. Code Sec. 1411(a)(2)(A).

[82] Proposed Reg. §1.1411-3(c)(1)(ii)(B). For an estate or trust, the threshold is the dollar amount at which the highest tax bracket for trusts and estates begins in the applicable tax year. Code Sec. 1411(a)(2).

[83] Proposed Reg. §1.1411-4(f)(1)(i).

[84] "Above-the-line" deductions apply to reduce adjusted gross income (AGI), whereas itemized or "below-the-line" deductions are only subtracted thereafter in determining taxable income. *Compare* Code Sec. 62 and 63. Above-the-line deductions are generally subject to fewer restrictions.

[85] Proposed Reg. §1.1411-4(f)(2).

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[86] Proposed Reg. §1.1411-4(f)(3)(i).

[87] Proposed Reg. §1.1411-4(f)(3)(ii). These limitations are provided in Code Secs. 67 (two-percent floor on miscellaneous itemized deductions) and 68 (overall limitation on itemized deductions reducing allowable deductions by the lesser of (1) three percent of adjusted gross income in excess of the applicable amount or (2) 80 percent of the otherwise allowable itemized deductions).

[88] Proposed Reg. §1.1411-4(f)(1)(ii).

[89] Proposed Reg. §1.1411-4(f)(4).

[90] *Net Investment Income Tax, supra* note 1, at 72613.

[91] *See* Proposed Reg. §1.1411-4(d)(3)(i). ("Net gain attributable to the disposition of property is the gain described in section 61(a)(3) ... .") and (f)(1)(ii) ("Any deductions ... in excess of ... gross income and net gain shall not be taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1.") *See also* Proposed Reg. §1.1411-4(h), Example 1.

[92] Proposed Reg. §1.1411-4(d)(3).

[93] *Id.*

[94] Code Sec. 1031.

[95] Code Sec. 1202(a). Depending on the year of issuance and type of small business, at least 50 percent, and up to 100 percent, of the gain is excluded.

[96] Using qualified small business stock, rather than S corporation stock, is a potential alternative strategy for Passive investors to minimize or eliminate NIIT exposure on disposition of the stock. Many businesses may not be able to meet all of the requirements under Code Sec. 1202, however. A full discussion of the requirements for excluding gain from qualified small business stock is beyond the scope of this article.

[97] Proposed Reg. §1.1411-4(c)(2).

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