

Self-Employment Tax and Net Investment Income Tax on Income from LLCs, Partnerships, and S Corporations

James R. Browne

214.651.4420

Jim.Browne@Strasburger.com

April 21, 2015

Agenda

- Background on SET and NIIT
- Overview of NIIT
- Self-Employment Tax on LLC Members
- Passive Activity Loss Rules and NIIT
- Rental Activities and Real Estate Professionals
- Planning Opportunities
- Possible Legislative and Administrative Changes

Background on SET and NIIT

Background

- **Supplemental taxes (beginning 2013)**
 - **Wages (“FICA”)**
 - 15.3% on base amount*; 2.9% on excess
 - Paid ½ by employer and ½ by employee
 - **Additional 0.9% employee tax on excess wages of high-income individuals**
 - **Earnings from self-employment (“SET”)**
 - 15.3% on base amount* adjusted for wages; 2.9% on excess
 - **Additional 0.9% tax on excess self-employment earnings of high-income individuals**
 - **Investment income (“NIIT”)**
 - **New 3.8% tax on net investment income of certain high-income taxpayers**

*\$118,500 for 2015 (indexed)

Background

- **FICA and SET 0.9% additional tax**
 - Affected (high-income) taxpayers
 - Individuals with wages/self-employment income in excess of:
 - \$250,000 joint
 - \$125,000 separate
 - \$200,000 individual and other
 - None of these thresholds is indexed
 - Exempt: corporations, estates, and trusts
 - The additional tax is subject to withholding or estimated tax payments along with applicable FICA or SET

Background

- **Net investment income tax (“NIIT”)**
 - Affected (high-income) taxpayers
 - Individuals: same thresholds as for FICA/SET
 - Domestic trusts and estates: highest tax bracket taxpayers (\$12,500 for 2015)
 - Exempt: corporations, nonresident aliens, foreign trusts, and tax-exempt or charitable trusts
 - Paid as part of estimated tax

Background

- **Legislative head fake:**
 - Although placed in Chapter 2A, titled “Unearned Income Medicare Contribution,” and therefore often referred to as the “Medicare tax,” the revenues from the NIIT go to general revenues and are not earmarked for Medicare



Background

- **NIIT Final Regulations (11/26/2013)**
 - Generally effective for tax years beginning on or after **Jan. 1, 2014**, but may be relied on for prior tax years
 - Any inconsistent positions in 2013 require reasonable adjustments in 2014 and future taxable years
- **NIIT Proposed Regulations (12/2/2013)**
 - Special provisions for estates and trusts, definition of NII, and dispositions of interests in partnerships and S corporations
 - Same effective date as Final Regulations
 - Any more restrictive provisions of subsequent final regulations will be prospective only
 - Any elections made under the Proposed Regulations will be in effect and remain in effect for all subsequent taxable years

Overview of NIIT

Application of the NIIT

- **Individuals**

- 3.8% of the lesser of
 - (a) net investment income (“NII”), or
 - (b) excess of modified adjusted gross income (“MAGI”) over threshold amount.
- MAGI: adjusted gross income (“AGI”) calculated under Section 62 plus net foreign earned income, and adjusted for income from CFCs and PFICs (to conform to amounts included in NII; see below)
- Threshold amounts (not indexed):
 - \$250,000 joint;
 - \$125,000 separate;
 - \$200,000 individual and other
(same as FICA/SET)

Application of the NIIT

- **Example**

- Bob and Sally are married and file a joint return. Their MAGI is \$300,000, of which \$200,000 is wages and \$100,000 is dividend and interest income.
- The amount subject to NIIT is \$50,000, calculated as the lesser of
 - (a) \$100,000 NII and
 - (b) the excess of \$300,000 MAGI over \$250,000 threshold.



Application of the NIIT

- **Trusts and estates**
 - 3.8% of the lesser of:
 - (a) undistributed net investment income, or
 - (b) excess of AGI calculated under Section 67(e) over the highest income tax bracket threshold for trusts and estates (**\$12,300 for 2015**)
 - AGI is adjusted for income from CFCs and PFICs (to conform to amounts included in NII)

Net Investment Income

- **Net investment income** (“NII”) is the excess of
 - investment income, over
 - deductions properly allocable to investment income (“properly allocable deductions, or “PADs”)
- Income subject to SET excluded

Investment Income

- **Investment income** is the sum of:
 - **Category 1**: gross income from interest, dividends, annuities, royalties, and rents, not derived in the ordinary course of an *Active Non-Trading Business* (defined next slide);
 - **Category 2**: other gross income derived from a business that is either (a) a Passive Activity, or (b) a Trading Business (i.e., not from an Active Non-Trading Business); and
 - **Category 3**: net gain attributable to the disposition of property (other than property held in an Active Non-Trading Business)

Investment Income

- **Classification of businesses**

- **“Active Non-Trading Business”** is a business that is *neither*
 - A Passive Activity, *nor*
 - A Trading Business
- **“Passive Activity”**
 - A Passive Activity is a trade or business which is a passive activity with respect to the taxpayer within the meaning of Section 469 (*generally* meaning the **taxpayer does not materially participate** in the business)
- **“Trading Business”**
 - A Trading Business is a trade or business of **trading in financial instruments or commodities**
 - Financial instruments include stocks and other equity interests, debt, and derivatives, or interests in such financial instruments (e.g., short sales)
 - Commodities is defined by reference to Section 475(e)(2)

Investment Income

- **Working capital income** [Reg. 1.1411-6]
 - Gross income from, and net gain attributable to, the investment of working capital is treated as not derived in the ordinary course of a trade or business
 - *Result: income attributable to investment of working capital of an Active Non-Trading Business is subject to NIIT*
 - In determining if any item is attributable to the investment of working capital, principles similar to those described in Reg. 1.469-2T(c)(3)(ii) apply
 - That regulation is part of the passive activity loss rules and deals with the distinction between portfolio income and income derived in the ordinary course of business

Investment Income

- **Guaranteed payments** [Prop. Reg. 1.1411-4(g)(10)]
 - **Guaranteed payments for use of capital**
 - Generally included in NII under Category 1 (interest, dividends, etc.)
 - Probably classified as interest and eligible for self-charged interest exception [*cf.* Reg. 1.469-2(e)(2)(ii)]
 - **Planning:** Preferred returns may be economically equivalent to guaranteed payments for use of capital, but are often reported as an allocable share of partnership income
 - **Guaranteed payments for services**
 - Excluded from NII
 - Likely subject to SET

Investment Income

- **Payments to retiring or deceased partner** [Prop. Reg. 1.1411-4(g)(11)]
 - **Sec. 736(b) payments for interest in partnership property**
 - Gain or loss is treated as gain or loss from the disposition of a partnership interest (see below)
 - **Sec. 736(a)(1) distributive share payments**
 - Characterized by reference to the character of the distributive share items [*cf.* Reg. 1.469-2(e)(2)(iii)]
 - Passive/active status fixed at liquidation date for payments not in excess of the value of former partner's interest in the partnership
 - **Sec. 736(a)(2) guaranteed payments**
 - Payments for unrealized receivables and goodwill treated as gain from the disposition of a partnership interest (see below)
 - Other payments are characterized as a payment for services or payment of interest based on whether the payment is for services or use of capital

Investment Income

- **Common types of excluded income**

- Interest income on tax exempt bonds
- Income from qualified retirement plans
- Social security benefits
- Alimony
- Wages and self-employment income

- **Hidden tax on excluded income**

- To the extent excluded income is included in AGI, the income can cause NII otherwise below the threshold to be taxable

- In the example on slide 11, if Bob or Sally also recognize \$50,000 in qualified retirement plan income, the increase in their MAGI causes an additional \$50,000 of investment income to be subject to 3.8% NIIT



Investment Income

- **Self-charged interest** [Reg. 1.1411-4(g)(5)]
 - Interest income received from a non-passive activity of the taxpayer is excluded from NII generally to the extent of the taxpayer's allocable share of the interest expense
 - Does not apply if the interest expense is taken into account in determining self-employment income
 - If loan is made by one passthrough entity to another, taxpayer must have identical ownership interest in both entities [Reg. 1.469-7(e)]

Investment Income

- **Self-charged rent** [Reg. 1.1411-4(g)(6)]
 - Rent received from an activity in which the taxpayer materially participates is excluded from NII
 - 100% exclusion, regardless of share of rent expense
 - Exclusion does not depend on whether rent expense reduces SET
 - No identical ownership requirement for transactions between entities
 - Gain or loss from property rented to an activity in which the taxpayer materially participates is excluded from NII



Investment Income

- **CFCs and PFICs** [Reg. 1.1411-10(g)]
 - **General Rule**
 - Income inclusions with respect to stock of CFCs and PFICs are not dividends for regular tax purposes [Sections 951(a); 1293(a), 1296(a)] and therefore CFC and PFIC income inclusions are not within any category of NII
 - CFC or PFIC stock disposition gain generally is NII
 - To ensure that CFC and PFIC income inclusions are eventually included in the NII calculation when received as an actual dividend, taxpayers must separately track basis and previously taxed income (“PTI”) for NIIT purposes

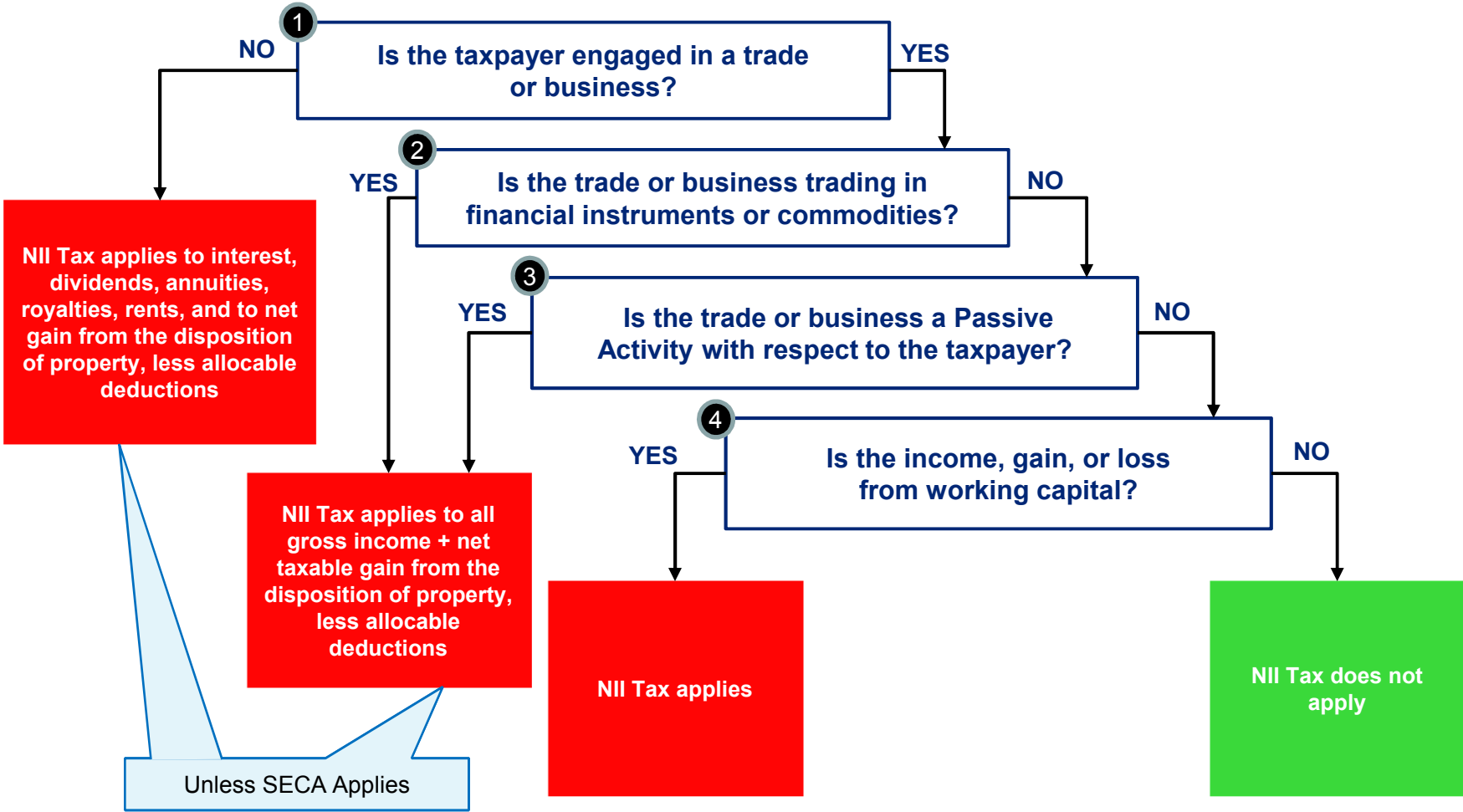
Investment Income

- **CFCs and PFICs (con't)**

- **Special Election**

- A taxpayer may elect to include CFC or PFIC income inclusions in NII, and thereby avoid the need to separately track basis and PTI for NIIT purposes
 - The election is made in the first year beginning after calendar year 2013 in which there is a CFC or PFIC income inclusion
 - A passthrough entity level election is permitted
 - CFC by CFC and PFIC by PFIC election permitted

NIIT Flowchart



Properly Allocable Deductions

- **General rule:** [Reg. 1.1411-4(f)]
 - **Deductions under Section 62 (above-the-line deductions)**
 - Deductions allocable to rents and royalties
 - Deductions allocable to income from Passive/Trading Business
 - Early withdrawal penalties
 - Section 1411 net operating loss amount [Reg. 1.1411-4(h)]
 - **Deductions under Section 63(d) (itemized deductions)**
 - Investment interest and investment expenses
 - State, local, and foreign income taxes
 - Annuity loss under Section 72(b)(3)
 - Estate and generation skipping taxes
 - Tax compliance expenses under Section 212(3)
 - Amortizable bond premium
 - Fiduciary expenses
 - **Section 165 loss deductions (see below)**
 - Ordinary loss on contingent payment and inflation-indexed debt

Properly Allocable Deductions

- **Section 165 losses** [Reg. 1.1411-4(f)(4)]
 - Netting/ordering rule:
 - First offset against net gain from the disposition of property (Category 3)
 - Then allowed as a properly allocable deduction (Category 1 or 2)
 - Good news for traders: trading losses will net against trading gains
- **Itemized deduction limits** [Reg. 1.1411-4(f)(7)]
 - Deductions subject to 2% floor on itemized deductions or the overall limitation on itemized deductions are allowable for NIIT purposes only to the extent deductible for regular tax purposes
- **Nondeductible items**
 - Moving expenses, alimony, IRA contributions, personal charitable contributions, personal medical expenses, personal residence mortgage interest, and itemized sales taxes
 - See Form 8960 instructions (2013), page 14

Properly Allocable Deductions

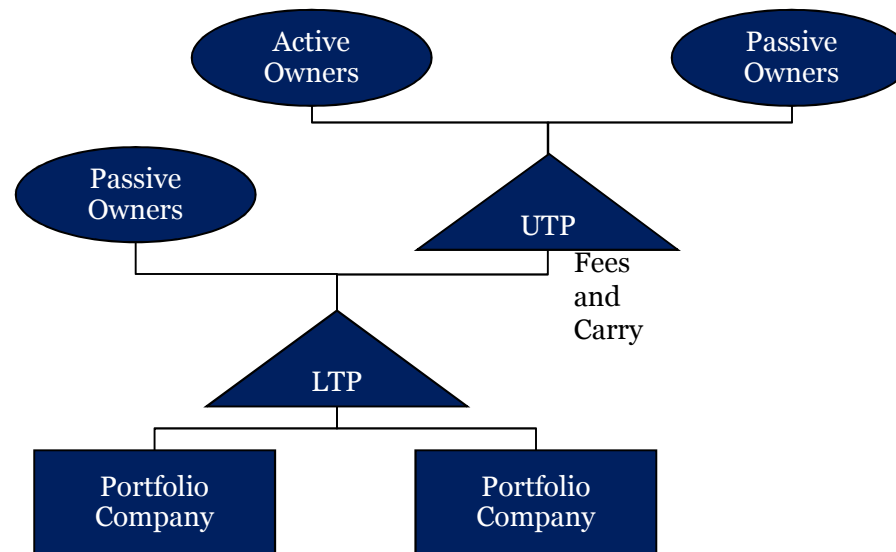
- **Special rules** [Reg. 1.1411-4(g)]
 - **Allocation of PADs** between NII and excluded income
 - Applies to state, local, and foreign income taxes, tax compliance expenses, and fiduciary expenses [Form 8960 instructions]
 - Use any reasonable method, including ratio of NII to AGI
 - **Recoveries of PADs:** if not otherwise included in NII, reduces PADs in year of recovery

Passthrough Entities

- **Character of a passthrough entity's income**
 - If an entity taxed as a partnership or S corporation (a “passthrough entity”) is not engaged in a business or rental activity, its income will typically be NII to its owners (as either Category 1 income or Category 3 net gains)
 - If a passthrough entity is engaged in a business or rental activity, the determination whether the entity's income is:
 - (a) Derived in a Passive Activity is made at the owner level; and
 - (b) Derived in a Trading Business is made at the entity level
- **Tiered passthrough entities**
 - A passthrough entity's income retains its character as NII or not as it passes through to upper-tier passthrough entities

Passthrough Entities

- **Example**



- LTP is an investment fund earning only interest, dividends, and capital gains
- All LTP income is NII to all owners (active and passive)
- UTP is engaged in the investment fund management business. UTP's management fee income is not NII as to its owners who materially participate in UTP's business (active owners), but is NII as to other owners (passive owners)

Passthrough Entities

- **Dispositions of passthrough entity interests** [Prop. Reg. 1.1411-7]
 - General rule: included in Category 3 investment income
 - Exception: If a passthrough entity directly or indirectly conducts an Active Non-Trading Business, net gain or loss on disposition of an interest in the passthrough entity is allocated between NII and other income
 - Allocation methods
 - **Primary reporting method** (look-through rule)
 - **Optional simplified reporting method** (historical NII % rule)
 - Installment sales (including private annuity sales)
 - Character of gain determined in year of sale

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**
 - **Primary reporting method (look-through rule)**
 - For dispositions resulting in gain under Chapter 1 (“regular tax”), the transferor’s net gain included in NII (Category 3) equals the lesser of:
 - The gain recognized on the sale for regular tax purposes, or
 - The transferor’s allocable share of net gain (if any) from a deemed sale of the passthrough entity’s property which, if sold, would give rise to gain or loss that is includable in determining the transferor’s NII (calculated asset-by-asset); [*cf.* Reg. 1.469-2T(e)(3)]
 - Similar rules apply when transferor recognizes loss (lesser of loss on sale of interest or allocable share of net loss from deemed asset sale)
 - Entity may be required to report unrealized gains and losses

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**

Gain example

A/B partnership has two partners: A owns 25% and B owns 75%.

B's basis for his partnership interest is \$120x.

A/B's assets are as follows:

<u>Asset</u>	<u>Basis</u>	<u>FMV</u>
Investment asset	\$60x	\$100x
Business asset	<u>\$100x</u>	<u>\$300x</u>
Total	<u><u>\$160x</u></u>	<u><u>\$400x</u></u>

B sells his interest to C for \$300, recognizing a gain of \$180x.

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**

Gain example (con't)

1. B's gain for regular tax purposes = \$180x
2. B's allocable share of A/B's NII gain on an asset sale
 - Investment asset deemed gain = \$40x
 - B's allocable share = \$30x

Lesser of 1 or 2 = \$30x

Result: \$30x of B's \$180x gain is treated as NII

If A/B's investment asset had a built-in loss, none of B's gain would be included in NII; investment asset built-in loss produces no NIIT benefit.

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**

Loss example

A/B partnership has two partners: A owns 25% and B owns 75%.

B's basis for his partnership interest is \$270x.

A/B's assets are as follows:

<u>Asset</u>	<u>Basis</u>	<u>FMV</u>
Investment asset	\$60x	\$100x
Business asset	<u>\$300x</u>	<u>\$100x</u>
Total	<u><u>\$360x</u></u>	<u><u>\$200x</u></u>

B sells his interest to C for \$150, recognizing a loss of \$120x.

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**

Loss example (con't)

1. B's loss for regular tax purposes = \$120x
2. B's allocable share of A/B's NII loss on an asset sale = \$0x
(A/B has no assets that would produce a loss for NII purposes)

Lesser of 1 or 2 = \$0x

Result: \$0 of B's \$120x loss is treated as NII

If A/B's business asset had a built-in gain, the investment asset built-in loss would be offset against the business asset gain and produce no NIIT benefit.

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**
 - **Optional simplified reporting method (historical NII % rule)**
 - NII = disposition gain x percentage of income allocated to the taxpayer during the holding period that was NII
 - Should not require information regarding the entity's unrealized gain or loss for its assets
 - **Qualification Requirements**
 - A transferor can use the optional method only if the transferor
 - (a) is an eligible holder; and
 - (b) either of both of the following requirements are met:
 - » 5% Threshold: The transferor's allocable share NII items is $\leq 5\%$ of the transferor's total allocable share income and the disposition gain is $\leq \$5\text{MM}$; or
 - » Gain Threshold: The total disposition gains during the year are $\leq \$250,000$

Passthrough Entities

- **Dispositions of passthrough entity interests (con't)**
 - **Optional simplified reporting method (con't)**
 - Eligible holder: A holder of an interest in a passthrough entity is not eligible to use the simplified reporting method if any of the following conditions are met [Reg. 1.1411-7(c)(3)]
 - A transfer of an interest held for <12 months
 - Holder transferred NII property to, or received NII property from the entity during the Section 1411 Holding Period as part of a plan that includes the disposition of the entity interest;
 - A transfer of a partnership interest other than a proportionate interest;
 - Holder knows or has reason to know that the entity's gross NII assets have increased or decreased by 25 percentage points or more during the Section 1411 Holding Period due to asset acquisitions or dispositions;
 - The entity is a C corporation that elects S corporation status during the Section 1411 Holding Period

Self-Employment Tax on LLC Members

SET on LLC Members

- **Issue**

- *Can an LLC member treat any portion of the member's distributive share of LLC income as exempt from SET under the exception for limited partner distributive share income?*
- First step in a two-step analysis:
 1. Avoid SET
 2. Avoid NIIT

SET on LLC Members

- **Imposition of SET**

- SET is imposed on “net earnings from self-employment”
- Generally defined as gross income derived by an individual from any trade or business (including a partnership), less the allowable deductions attributable to such trade or business
- Exclusions for rents, non-dealer dividends and interest, capital gains and losses, and certain other items
- Does not apply to an S corporation shareholder’s distributable share of S corporation earnings

SET on LLC Members

- **The SET limited partner exception - 1402(a)(13)**
 - In computing net earnings from self-employment:
 - Include the *“distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member”*
 - Exclude (in addition to normal exclusions for rents, dividends, interest, gains, etc.):
 - *“the distributive share of any item of income or loss of a limited partner, as such,*
 - *other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services”*
 - Does the limited partner exception apply to LLC member interests?

SET on LLC Members

- **Purpose for the limited partner exception**
 - Before enactment of 1402(a)(13) in 1977, persons ineligible for social security benefits were buying passive, limited liability investments in partnerships that promised to generate self-employment income eligible for such benefits
 - Congress enacted 1402(a)(13) to curtail “buying” social security benefits through limited partner investments
 - While the statute targets passive limited partners earning investment type income, the statute is not limited to such persons
 - *The statute expressly contemplates that a limited partner may provide services to the partnership and earn a guaranteed payment for such services and still have distributive share income excluded from SET and related benefit accruals*



SET on LLC Members

- **The 1997 proposed regulations** [Prop. Reg. 1.1402(a)-2]
 - **Context (20 years later):**
 - Traditional restrictions on limited partner management activities eroding
 - Growing use of alternative forms of tax partnerships with full or partial limited liability for managing members (LLCs, LLPs, and LLLPs)
 - Increasing SET rate relative to benefits
 - **General rule:** a “limited partner” is any individual unless the individual:
 - has personal liability as a partner for the partnership’s debts, or
 - has authority (under the law of the jurisdiction in which the partnership is formed) to contract for the partnership, or
 - participates in the partnership's business for more than 500 hours during the partnership’s taxable year, or
 - is a service partner in a service partnership

SET on LLC Members

- **The 1997 proposed regulations (con't)**
 - **Class of interest exceptions**
 - More than one class of interest
 - An individual is a limited partner with respect to a class of interest in which limited partners (as defined above) own a substantial, continuing interest and in which the individual's rights are identical to such limited partners
 - One class of interest
 - An individual who participates in the business for >500 hours is a limited partner if the individual's rights are identical to all other partners who are limited partners and who own a substantial, continuing interest
 - Exceptions intended to exclude from SET amounts that “are demonstrably returns on capital invested in the partnership”
 - A service partner in a service partnership is never a limited partner to any extent (i.e., no class of interest exception)
 - Service partnership: substantially all activities involve performing health, law, engineering, architecture, accounting, actuarial science, or consulting services

SET on LLC Members

- **Congress responds**

- The 1997 proposed regulations sparked a firestorm of criticism
 - Critics argued that earnings from self-employment should be limited to the fair value of services performed, and should not sweep in all income of the business based on arbitrary factors such as the number or hours worked or the nature of the business
- Congress was sympathetic to these arguments and promptly passed legislation prohibiting the Treasury from finalizing regulations with respect to the definition of limited partner under 1402(a)(13) until July 1, 1998
- The Senate bill expressed the Senate’s view that the proposed regulations should be withdrawn and that **“Congress should determine the tax law governing self-employment income”**

SET on LLC Members

- **Passive activity loss cases**

- *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Or. 2000)
- *Garnett v. Comm’r*, 132 T.C. 368 (2009)
- *Thompson v. United States*, 87 Fed. Cl. 728 (2009)
- *Hegarty v. Comm’r*, Tax Ct. Sum. Op. 2009-153
- *Newell v. Comm’r*, T.C. Memo. 2010-23

These cases address the question whether an LLC member is a limited partner for purposes of the *passive activity loss rules*

SET on LLC Members

- **Passive activity loss cases (con't)**

- **Issue**

- A “limited partner” cannot use the general 7-factor test for material participation and must satisfy a more restrictive 3-factor test
- Temporary regulations define limited partner solely by reference to limited liability, without regard to participation in management
- IRS argues that an LLC member has limited liability and is therefore a limited partner for material participation purposes

- **Holdings**

- IRS loses every case
- Some cases hold that an LLC member is not subject to the limited partner test because an LLC is not a limited partnership
- Other cases hold that an LLC member is a general partner on the theory that one who is not a limited partner must be a general partner

SET on LLC Members

- **Passive activity loss cases (con't)**
 - A concern is that the reasoning of the passive activity loss cases could be applied in the context of Section 1402(a)(13) (the SET limited partner rule) to deny LLC members limited partner status for SET purposes
 - Counterargument: the passive activity loss cases are not authoritative or instructive with respect to the SET limited partner rule because:
 - a. The statutory language and policies of the passive activity limited partner rule differ significantly from the statutory language and policies of the SET limited partner rule
 - b. The reasoning of the cases is dubious and inconsistent, and was likely influenced by the questionable validity of the temporary regulation

SET on LLC Members

- **Passive activity loss cases (con't)**
 - Subsequent development
 - Prop. Reg. 1.469-5 (2011) redefines a limited partner (for purposes of the passive activity loss rules) as a person having limited liability and lacking local law rights to manage the entity
 - The proposed amendments to the passive activity loss regulations is additional evidence that the passive activity loss cases are not authoritative with respect to the issue whether the SET limited partner rule extends to LLC members

SET on LLC Members

- **SET cases and rulings**

- *Renkemeyer, Campbell & Weaver, LLP v. Comm’r*, 136 T.C. 137 (2011)
 - Law firm organized as a general partnership electing LLP status
 - » Court could have summarily disposed of the case on the ground that the taxpayers were general partners under state law, but it did not
 - Abusive facts: transitory corporate holding company; missing partnership agreement; failure to allocate income and distributions according to alleged sharing ratios; low or no compensation for services
 - Court discusses the legislative history of 1402(a)(13)
 - » Intent to exclude “earnings that are basically of an investment nature”
 - » The legislative history “does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners”
 - Because the taxpayers’ distributive share income arose exclusively from legal services they performed on behalf of the partnership, and was not a return on investment or of an investment nature, the income was subject to SET

SET on LLC Members

- **SET cases and rulings (con't)**

- *Riether v. United States*, 919 F. Supp. 2d 1140 (D. NM 2012)
 - LLC operates a medical diagnostic imaging business; members receive wages and distributive share income from the LLC; no SET on distributive share
 - Taxpayers assert
 - » They can't be self-employed because they received wages
 - » The distributive share income was not earned income from self-employment and therefore is exempt from SET;
 - No evidence wages were reasonable compensation for services
 - Held: distributive share income is subject to SET because taxpayers were effectively general partners
 - » “Plaintiffs are not members of a limited partnership, nor do they resemble limited partners, which are those who ‘lack management powers but enjoy immunity from liability for debts of the partnership.’ [Renkemeyer] Thus, whether Plaintiffs were active or passive in the production of the LLC's earnings, those earnings were self-employment income.”

SET on LLC Members

- **SET cases and rulings (con't)**

- *Howell v. Comm'r*, T.C. Memo 2012-303
 - Medical technology company (LLC) formed by W and B; H (W's spouse) managed the business with B; LLC paid guaranteed payments to H, B, W and others, leaving only small amounts of distributive share income for W and B
 - IRS assesses SET on guaranteed payments
 - » Notably, there is no indication that the distributive share income was subjected to SET
 - H&W “appear to contend” that W was a limited partner not active in the business and her guaranteed payments were either limited partner distributive share income or not payments for services
 - Held:
 - » Taxpayers are bound by the form of their tax reporting (guaranteed payment)
 - » W performed some services for the LLC, but failed to prove what portion of the guaranteed payments were for services

SET on LLC Members

- **SET cases and rulings (con't)**

- CCA 201436049 (May 20, 2014)

- Investment fund management company organized as an LLC; members were paid a salary, a guaranteed payment for parking and health benefits, and a distributive share; no SET on distributive share
- Members contributed varying amounts of capital to the LLC
- Held: entire distributive share income is subject to SET because the income “is not income which is basically of an investment nature of the sort that Congress sought to exclude from [SET] when it enacted the predecessor to §1402(a)(13). Accordingly, [the members] are not limited partners within the meaning of §1402(a)(13).”
 - » No analysis whether the salary and guaranteed payments represented reasonable compensation for services
 - » No analysis whether the distributive share income was attributable to capital contributions, profits on employee labor, or other non-service factors

SET on LLC Members



- **Where are we now?**
 - **Reporting position: *the distributive share income of an active LLC member is exempt from SET provided the member is paid reasonable compensation for services rendered to the LLC***
 - This position is easily reconciled with the statute and legislative history, including the arguments that led to the 1997 Congressional moratorium
 - It is consistent with the treatment of S corporations
 - It is consistent with the recent cases on their facts (because in each case the taxpayers failed to establish that they received reasonable compensation for their services to the LLC)
 - IRS position that distributive share income of an active partner is always subject to SET is plainly contrary to the statute and Congressional intent (as expressed in 1997), and contrary to its litigating position in *Howell*
 - Service partners in service partnerships have more risk
 - Members of member-managed LLCs have more risk

Passive Activity Loss Rules and NIIT

Relevance

- To avoid NIIT on distributive share income from a passthrough entity, the income must be from an Active Non-Trading Business (i.e., must not be from a Passive Activity)
- NIIT rules refer to the Section 469 passive activity loss rules to:
 - Define a passive activity (including material participation)
 - Group activities for testing passive activity status
 - Classify rental activities as passive or active
 - Other

Passive Activity Loss Rule

- Section 469 disallows the “passive activity loss” for any tax year
 - Passive activity loss = amount by which aggregate losses from all passive activities for a tax year exceed aggregate income from all passive activities for the year
- The disallowed loss is carried forward and allowed as a passive activity loss in the following tax year
- Dispositions
 - When the taxpayer’s entire interest in the passive activity is disposed of in a fully taxable transaction, any loss from the activity (including prior years’ suspended losses) not otherwise utilized is treated as a loss which is not from a passive activity
- Key element is defining a “passive activity”

Passive Activity

- The term “**passive activity**” means
 - 1) Any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate, and
 - 2) Any rental activity (regardless of business/investment status or material participation, but subject to some exceptions)
- Working interest exception
 - Passive activity excludes any working interest in any oil and gas property that the taxpayer holds directly or through a non-limited liability entity (regardless of material participation)
- Passthrough entities
 - Whether a taxpayer’s allocable share of items from a passthrough entity are included in passive activity loss is determined by reference to the taxpayer’s participation in the entity’s activity

Passive Activity Planning

- **General planning implications**
 - **Loss producing business/rental activities:**
 - Avoid passive activity status for loss generating business/rental activities to avoid suspended losses
 - Less concern if losses are limited by basis or at-risk rules, or if taxpayer has ample passive activity income from other sources
 - **Income producing business/rental activities:**
 - Prior to the NIIT, taxpayers preferred passive activity status for income producing business/rental activities because passive activity income is used to avoid limits on passive activity losses
 - Referred to as a “passive income generator” or “PIG”
 - After the NIIT, more likely that high-income taxpayers will want to avoid passive activity status for profitable business/rental activities
 - Any timing benefit under the passive activity loss rules must outweigh the permanent cost of the NIIT on passive activity income

Material Participation

- **Material participation by individuals** [Reg. §1.469-5T(a)]
T materially participates in and activity for a year if T satisfies any one of the following tests for the year:
 - 1) T participates for >500 hours
 - 2) T's participation is substantially all participation of all persons
 - 3) T participates for >100 hours and \geq any other person
 - 4) Activity is a significant participation activity (SPA) (>100, but <500 hours) and T's participation in all SPAs is >500 hours
 - 5) T materially participated in any 5 of last 10 years
 - 6) Activity is a personal service activity and T materially participated for any 3 prior years
 - 7) T participates on regular, continuous, and substantial basis (facts and circumstances)

Material Participation

- **Participation by an individual** [Reg. 1.469-5(f), -5T(f)]
 - Includes work done in any capacity by taxpayer and spouse
 - Excludes
 - *Make work.* Work not of a type customarily done by an owner and one of the principal purposes of which is to avoid the Section 469 limitations
 - *Investor activities.* Work done as an investor unless the individual is directly involved in day-to-day management or operations of the activity
 - Investor activities include studying and reviewing financial statements or operating reports, and preparing or compiling summaries or analyses of financial or operating results for the individual's own use
- **Proof of participation**
 - Any reasonable means establishing the nature of the services performed and the hours spent performing the services
 - Examples: appointment book, calendar, or narrative summary

Material Participation

- **Facts and circumstances test** [Reg. 1.469-5T(b)]
 - Participation must exceed 100 hours
 - Management services not counted unless
 - no other person performing management services receives compensation for such services (i.e., no paid on-site manager), and
 - no other person performs management services that exceed (by hours) the services performed by the taxpayer
 - Satisfaction of other participation standards not relevant
 - Exception: farming activity if requirements of Section 2032A(b)(4) or (5) (relating to retired or disabled taxpayers or surviving spouses) are met [Section 469(h)(3)]

Material Participation

- **Material participation by a trust or estate**
 - Must meet the facts and circumstances test
 - Legislative history: tested by reference to whether the “fiduciary, in his capacity as such, is so participating”
 - IRS takes a restrictive view
 - PLR 200733023 (activities of non-fiduciary special trustee do not count)
 - PLR 201317010 (activities of special trustee in capacity as an employee of an S corporation owned by the trust do not count)
 - Case law is more favorable
 - *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. TX 2003) (activities of trust employees and agents also count)
 - *Frank Aragona Trust v. Comm'r*, 142 TC No. 9 (2014) (same; activities of trustees who are also employees of the business also count)

Material Participation

- **Material participation by a limited partner**
 - General rule: no material participation by a limited partner
 - Exception 1: limited partner that is also a general partner, and meets one of the seven tests
 - Exception 2: limited partner that meets (a) the 500 hours test, (b) the 5-of-10 test, or (c) the prior 3 years test
- **Application to LLC members**
 - Case law generally exempts LLC members from limited partner rule
 - Some courts say the rule does not apply to LLCs
 - Some courts say LLC members are general partners
 - See slides 46 through 49
 - 2011 proposed regulations state that LLC members are limited partners if they have limited liability and have limited management rights at all times during the year [Prop. Reg. 1.469-5(e)]

Material Participation



- **Summary**

- For SET purposes, an LP/LLC member wants to be a passive “limited partner” to qualify under Section 1402(a)(13)
- For NIIT purposes, an LP/LLC member generally wants to materially participate in the LLC business (to avoid passive activity status)

- **Planning challenge**

- Can an LP/LLC member be sufficiently active in the business to avoid NIIT but still avoid SET?
 - Yes
 - See discussion in Planning Opportunities below

Grouping Activities

- **Relevance**

- By grouping separate activities into a single activity, participation in the activities may be combined to test material participation
 - **Example:** Activity A is a profitable Active Non-Trading Business, and Activity B is a related profitable Passive Activity. By grouping activities A and B, it may be possible to avoid NIIT on income from activity B.

- **Planning**

- Under prior law, it was often advantageous to not group activities (to preserve passive activity income from successful passive investments, and accelerate use of suspended losses on activities sold or terminated)
- Under current law, it might be advantageous to group activities so that profitable passive activities can become non-passive activities that generate neither NII nor self-employment income

Grouping Activities

- **Requirements**

- One or more business activities may be treated as a single activity (“grouped”) if the activities constitute an “appropriate economic unit” for the measurement of gain or loss for purposes of Section 469 [Reg. 1.469-4(c)(1)]
 - Appropriate economic unit depends on facts and circumstances
 - Generally, use any reasonable method to group activities
 - Five factors are given the greatest weight in determining whether activities constitute an appropriate economic unit:
 - Similarities or differences in the types of businesses;
 - Extent of common control;
 - Extent of common ownership;
 - Geographical location; and
 - Interdependence of the activities
- No meaningful guidance

Grouping Activities

- **Limitations on grouping** [Reg. 1.469-4(d)]
 - A rental activity can't be grouped with a trade or business activity unless they form an appropriate economic unit and
 - Rental activity is insubstantial in relation to business activity;
 - Business activity is insubstantial in relation to rental activity; or
 - Identical ownership
 - Can't group real property rental activity with personal property rental activity
 - An interest as a limited partner in special industry activities described in Section 465(c)(2) (film, depreciable personal property leasing, farming, oil and gas, and geothermal property) cannot be grouped with any other activity unless it is in the same type of business and part of an appropriate economic unit

Grouping Activities

- **Special re-grouping election** [Reg. 1.469-11(b)(3)(iv)]
 - A one-time regrouping election is available during the first taxable year that NII exceeds the threshold amounts (first time Form 8960 would be filed)
 - Passthrough entities cannot make the regrouping election
 - Taxpayers may regroup on an amended return if the taxpayer was not subject to NIIT on original return (or previously amended return) and, if, due to a change to the original return, the taxpayer owed NIIT for that taxable year

Former Passive Activities

- A **former passive activity** is an activity that is not a passive activity for the current tax year but was passive for any prior tax year
- Suspended passive activity losses allocable to a former passive activity are
 - first offset against any income generated by the activity in the current tax year (even though not passive activity income), and
 - any remaining amount is a passive activity loss [Section 469(f)]
- If the income offset by these rules is NII, the losses so utilized will be treated as properly allocable deductions or net losses (as applicable) for purposes of NIIT [Reg. 1.1411-4(g)(8)]

Dispositions of Passive Activities

- Upon a complete disposition of the passive activity in a fully taxable transaction to a non-related party, losses from the activity are first offset against income from the activity, then against other passive activity income, and any excess loss is treated as non-passive [Section 469(g)]
- The excess (non-passive) loss is allowed for NIIT purposes as either properly allocable deductions or net loss in the same manner as taken into account for regular tax purposes [Reg. 1.1411-4(g)(9); T.D. 9644]
 - Excess operating deductions are properly allocable deductions
 - Excess losses are net loss
 - No guidance on tracing

Recharacterization Rules

- Income (not loss) from certain passive activities is treated as “not from a passive activity” [Reg. 1.469-2T(f)]

Passive activity	Income recharacterized as:
rental of nondepreciable property	portfolio income
equity-financed lending	
passthrough entity that licenses intangible property	
significant participation activities	active income
rental of property incidental to a development activity	
rental of property to a related non-passive activity (self-charged rental income)	

Recharacterization Rules

- **For NIIT purposes**
 - Income recharacterized from passive to portfolio is treated as Passive Activity income for NIIT purposes [Reg. 1.1411-5(b)(2)(iii)]
 - Income recharacterized from passive to active is treated as income from an activity that is not a Passive Activity for NIIT purposes [Reg. 1.1411-5(b)(2)(i)]

Recharacterization Rules

- **Significant participation activities (“SPAs”)**
 - If a taxpayer participates for >100 hours (but ≤500 hours) in each of several non-rental business activities (each a “significant participation activity” or “SPA”), and if the taxpayer participates for >500 hours in all such SPAs, the taxpayer is generally treated as materially participating in each SPA [Reg. 1.469-5T(a)(4)]
 - If the taxpayer falls short of the 500 total hours test and does not otherwise satisfy any applicable material participation test with respect to a SPA, the SPA is generally classified as a passive activity (a “passive SPA”)
 - BUT, in such a case, if the passive activity gross income from all passive SPAs exceeds passive activity deductions from all passive SPAs, a ratable portion of the net passive income of each income producing activity is recharacterized as active income [Reg. 1.469-2T(f)(2)]

Recharacterization Rules

- **Significant participation activities (“SPAs”) (con’t)**
 - **Example**

	<u>X</u>	<u>Y</u>	<u>Z</u>
Passive activity gross income	\$600	\$700	\$900
Passive activity deductions	<u>\$200</u>	<u>\$1,000</u>	<u>\$300</u>
Net passive income	<u>\$400</u>	<u>(\$300)</u>	<u>\$600</u>

Each activity is a passive SPA (>100 hours each, but ≤500 hours in total). Aggregate passive activity gross income (\$2,200) exceeds aggregate passive activity deductions (\$1,500). Therefore, the net passive income (\$700) is recharacterized as active income: \$280 of income from activity X ($\$400 \times 700/1000$), and \$420 of income from activity Z ($\$600 \times 700/1000$). Remaining \$300 of income from activities X and Z is passive and is offset by the \$300 loss from activity Y.

Recharacterization Rules



- **Significant participation activities (“SPAs”)**
(con’t)
 - **Planning Opportunity**
 - By participating in a profitable activity for more than 100 hours but not more than 500 hours, a limited partner or LLC member may be able to
 - avoid SET under the proposed regulations’ 500 hour test,¹ and
 - avoid NIIT under the passive activity income recharacterization rule [Reg. 1.1411-5(b)(2)(i)]

¹ Does not apply to a partner having management authority or who is a service partner in a service partnership.

Recharacterization Rules

- **Rental Incident to Development** [Reg. 1.469-2(f)(5)]
 - Net income from rental property is not from a passive activity if
 - The property is disposed of at a taxable gain during the year;
 - The use of the property in an activity involving the rental of the property commenced less than 12 months before the date of disposition; and
 - The taxpayer materially or significantly participated for any taxable year in an activity that involved for such year the performance of services (such as construction, renovation, or lease-up) to enhance the value of the property or any carryover basis property
 - Example: taxpayer purchases land, constructs a building, and rents the building for less than one year prior to disposition. Gain from the disposition in excess of prior operating losses is treated as not from a passive activity

Recharacterization Rules

- **Self-charged rent**

- For passive activity loss purposes, rental income is recharacterized from passive to active if the property is rented to a trade or business activity in which the taxpayer materially participates [Reg. 1.469-2(f)(6)]
- For NIIT purposes, the recharacterized rental income is deemed to be derived in the ordinary course of a trade or business even if the rental activity does not constitute a trade or business [Reg. 1.1411-4(g)(6)]
- **Planning opportunity**
 - Self-charged rents can create income subject to neither NIIT nor SET
 - Compare rule for self-charged interest (exception for interest deducted in computing self-employment income) [Reg. 1.1411-4(g)(5)]

Rental Activities and Real Estate Professionals

Rental Activities

- **General rule**: Under the passive activity loss rules, a rental activity is always passive, regardless of whether
 - the activity constitutes a business and the taxpayer materially participates in the business, or
 - the activity is so passive that it does not constitute a business at all (i.e., is a portfolio investment)[Section 469(c)(2)]
- **NIIT implications**: Under the general rule for rental activities, rental income is NIIT regardless of material participation

Rental Activities

- **Exceptions**: The following rental activities may be characterized as other than a passive activity
 - A rental real estate activity that constitutes a trade or business and in which a real estate professional materially participates
 - Certain specifically excepted rental activities (including short-term rentals, or longer rentals when significant or extraordinary personal services are provided, incidental rentals, etc.) [Reg. 1.469-1T(e)(3)(ii)]
 - Rental activities “grouped” with trades or businesses in which the taxpayer materially participates (permitted in only limited circumstances)
 - Rental activities that generate income not from a passive activity under the recharacterization rules (e.g., rental of property incidental to development, or self-charged rental income)

Real Estate Professionals

- **Two requirements** [Sec. 469(c)(7)(B)]
 - 50% of time test: More than half of personal services performed in trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates
 - 750 hour test: Taxpayer performs >750 hours of services during the tax year in real property trades or businesses in which taxpayer materially participates
 - Examples
 - T participates in activity A for 700 hours, and in each of activities B, C, and D for 400 hours each. T flunks both tests.
 - T participates in activity A for 700 hours, and in each of activities B, C, and D for 200 hours each. T flunks 750 hour test.
 - T participates in activity A for 900 hours, and in each of activities B, C, and D for 400 hours each. T flunks 50% of time test.

Real Estate Professionals

- Qualifying services exclude services performed as an employee, unless the employee is a “5-percent owner” of the employer
- Spouses filing a joint return qualify only if one spouse separately satisfies both requirements (but material participation test includes work of both spouses)
- For a closely-held C corporation, the requirements for real estate professional status are treated as met for a year if >50% of the corporation’s gross receipts for the year are derived from real property trades or businesses in which the corporation materially participates

Real Estate Professionals

- **Passive activity status**: A rental real estate activity of a real estate professional is not *per se* passive, but is passive unless:
 - the rental real estate activity qualifies as a trade or business; and
 - the taxpayer materially participates in the rental real estate activity
- **Grouping**: Each rental real estate activity of a real estate professional is treated as a separate activity, unless an election is made to group all such rental real estate activities as a single activity
 - Note that the grouping rules for determining real estate professional status allow grouping of rental and non-rental activities (which is generally not permitted under the general grouping rules)

[Reg. 1.469-9(c)]

Real Estate Professionals

- **NIIT Safe Harbor** [Reg. 1.1411-4(g)(7)(i)]
 - If a real estate professional materially participates in a rental real estate activity for more than 500 hours in the current year, or has participated in such real estate activities for more than 500 hours during any five of the preceding ten years, income from that rental activity is deemed to be derived in the ordinary course of a trade or business (i.e., excluded from NII)
 - Not necessary to establish that the rental real estate activity constitutes a trade or business

Planning Opportunities

Planning Trap #1

- **S corporations**

- The *properly determined* distributive share income of an S corporation engaged in an Active Non-Trading Business is unquestionably exempt from both SET and NIIT
- BUT
 - Owners must receive reasonable compensation for services
 - Professional services businesses may not benefit
 - S corporations have significant disadvantages as compared to tax partnerships (e.g., one class of stock, no entity or foreign shareholders, no 754 election, no 721/731 exclusion for gain on property contributions and distributions, no inside basis step-up at death, etc.)
 - The perceived SET/NIIT benefits are often overestimated
- *A properly structured LLC or LP should provide similar SET/NIIT benefits*

Planning Trap #2

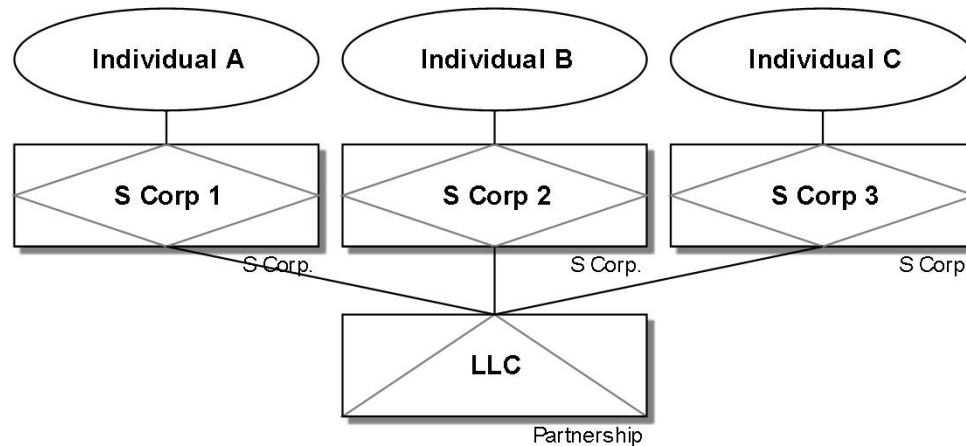


- **S corporation election for an LLC or LP**
 - Tax preparers or other tax advisors often elect S corporation status for an LLC or LP, assuming that an S corporation provides SET and NIIT advantages. **This is usually bad advice!**
 - Same considerations as any S corporation (see prior slide)
 - Plus additional potential problems if the company agreement is not modified
 - If the operating agreement provides for special allocations (which is common), the entity might not comply with the one class of stock requirement, and the entity might be classified as a C corporation!
 - Other provisions commonly found in the governing documents for an S corporation (e.g., restrictions on transfers of stock to ineligible shareholders) may also be absent from the LLC/LP operating agreement

Planning Trap #3

- **S corporation blocker**

- What if the LLC/LP interests are owned by single member S corps?



- Individuals are employees of LLC or S corp and are paid wages
- Distributive share income flows through S corporations
- NB: *Cumbersome and does not eliminate all disadvantages of S corporation ownership*

Planning Opportunities

- **Use of LLCs and LPs**

- **Reporting position** (slide 54)

- *The distributive share income of an active LLC member or limited partner (collectively, “LP”) should be exempt from SET and NIIT provided the LP is paid reasonable compensation for services rendered to the LLC or limited partnership*

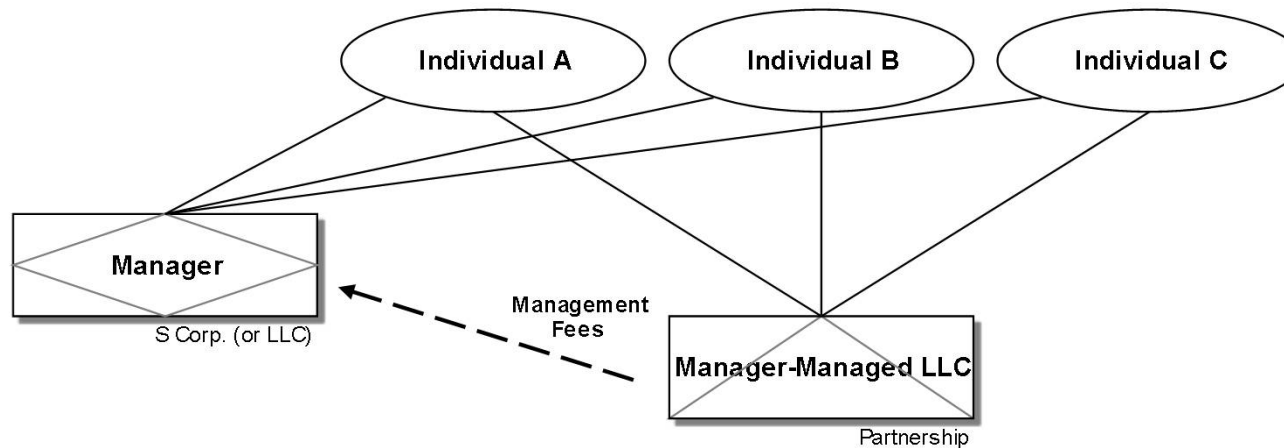
- **Planning**

- Organize the LLC as a manager-managed LLC and use a management company owned by the LLC members to act as the LLC manager
 - LLC members provide services to the LLC as employees of the manager
 - Management fees received by the manager are paid out to the LLC members as employee wages, and are set at levels sufficient to constitute reasonable compensation for the services rendered
 - In the case of a limited partnership, the manager is the general partner

Planning Opportunities



- Use of LLCs and LPs - example



- Individuals perform material participation services for LLC as employees of an S corporation (or LLC) manager entity
- Individuals have no management rights as members of the LLC
- Same structure can be used for a limited partnership (manager entity is the general partner)

Planning Opportunities



- **Significant participation “sweet spot”**

- A high income individual having a non-managing LP/LLC interest in a profitable Non-Trading Business can generally avoid SET and NIIT on distributive share income if participation in the activity exceeds 100 hours but is less than 500 hours (i.e., is significant but not material)
 - The individual’s distributive share income is exempt from SET (unless the individual has management authority or is a service partner in a service partnership) [Prop. Reg. 1.1402(a)-2]
 - The individual’s distributive share income is exempt from NIIT (either because the individual satisfies one of the material participation tests or because the income is classified as active income under the income recharacterization rules) [Reg. 1.1411-5(b)(2)(i)]

Planning Opportunities

- **Grouping elections**

- A one-time regrouping election is available during the first taxable year that NII exceeds the threshold amounts (first time Form 8960 would be filed) [Reg. 1.469-11(b)(3)(iv)]
- Regrouping (new taxpayer)
 - Estate/trust at first spouse's death
 - Transfer of activities to a trust (including change of grantor trust status)
 - Distribution of property out of trust/estate
- Consider grouping passive activities with Active Non-Trading Businesses to avoid NIIT on income from the passive activities
 - Consider tax effects of loss of passive activity income (capacity to absorb passive activity losses)

Planning Opportunities

- **Self-charged rent**

- Rental income from property used in an activity in which the taxpayer materially participates is characterized as Active Non-Trading Business income exempt from NIIT
- The fact that the rental expense reduces SET is not considered
- Example

A is a service partner in a service partnership (P) conducting an Active Non-Trading Business. A receives reasonable compensation for services provided and a distributive share of residual income. The IRS might characterize the residual income as compensation. If P's building is owned by a passthrough entity owned by A, rental expense paid by P will reduce residual income potentially subject to SET, but rental income received by A will be exempt from SET and NIIT.



Planning Opportunities

- **Partnership preferred returns**
 - Situation: interest income earned by a taxpayer on a loan to a partnership in which the taxpayer is a limited partner and in which the taxpayer materially participates is classified in whole or in part as NII (after taking into account the self-charged interest rules)
 - Planning: consider whether converting the loan to a preferred equity interest can convert the related income into income from an Active Non-Trading Business (i.e., the income is classified as distributive share income of the limited partner in his capacity as such)
 - Can also apply to LLC members

Planning Opportunities

- **Holding rental property in an IRA?**
 - IRA distributions are excluded from NII, leading some to suggest holding rental property in an IRA (particularly a Roth IRA)
 - Significant limitations requiring careful planning
 - Could have unintended and unfavorable tax consequences
 - See Ashley R. Schieck, *Structuring Real Estate Investments to Avoid the Net Investment Tax*, 41 J. Real Estate Tax'n (Q1 2014)

Planning Opportunities

- **Offset net gains with Sec. 165 losses**
 - Traditional loss harvesting strategies for portfolio securities
 - Worthlessness or abandonment losses
 - Section 165(g)(3) capital loss on worthless securities
 - *Pilgrim's Pride Corp. v. Comm'r*, 779 F.3d 311 (5th Cir. 2015) (ordinary loss on abandonment of non-worthless securities)
 - Capital loss taken on Schedule D (direct offset to net gains from capital assets) versus ordinary loss taken on Schedule A (subject to 2% floor and phase out limitations)
- **Defer net gains**
 - Exchanges under Sections 1031/1033/1038
 - Installment sales

Planning Opportunities

- **Trusts and estates**
 - A trust's or estate's NII is subject to NIIT at very low levels of AGI
 - A trust's or estate's NII can be reduced by distributing NII as part of "distributable net income" provided the beneficiary is not subject to NIIT (i.e., has MAGI below the applicable threshold)
 - NB: A trust or estate's capital gains are generally excluded from distributable net income and cannot be distributed out to beneficiaries for NIIT purposes [Section 643(a)(3)]
 - Successor trusts can provide new grouping elections

Planning Opportunities

- **Disposition of passthrough entity interest**
 - Election of primary (look-through) method or optional method
 - Because a sale of an interest can cause netting of entity-level NII losses against entity-level other gains, consider whether an actual sale of assets would generate tax savings from separately recognizing the entity-level NII items and other items
 - Defer and level out gain constituting NII using an installment sale

Possible Legislative and Administrative Changes

Proposals for Change

- **Joint Committee SET proposal (2005)**
 - Repeal limited partner exception
 - S corporation is treated as a partnership for SET purposes
 - Any partner or S corporation shareholder that does not materially participate in the entity's business pays SET only on reasonable compensation for services
 - Presumably, all residual distributive share income of such a partner or shareholder would be subject to NIIT

Proposals for Change

- **American Jobs and Closing Tax Loopholes Act (2010)**
 - Deals only with professional service businesses
 - Impose SET on distributive share income of each shareholder of a “disqualified S corporation” who provides substantial services with respect to the professional service business of the S corporation
 - Disqualified S corporation:
 - S corporation that is a partner in a partnership engaged in a professional services business and substantially all activities are in connection with such partnership
 - S corporation engaged in a professional services business if the principal asset is the reputation and skill of three or fewer employees
 - Impose SET on any limited partner who provides substantial services with respect to a partnership engaged in a professional services business

Proposals for Change

- **CBO SET proposals (2012)**
 - Material participation standard
 - Impose SET on distributive share income of partners who materially participate
 - Reasonable compensation standard
 - Impose SET only on reasonable compensation paid to owners (same as for S corporations)
 - Problem: reduces SET revenues by estimated 58% (based on underreporting observed for S corporations)
 - Safe-harbor calculation of capital income
 - Apply a prescribed rate of return to balance sheet net operating assets
 - Would not apply to S corporations
 - No accounting for intangibles and other off-balance sheet income producing assets

Proposals for Change

- **Carried interests**

- Treat a partner’s distributive share of net income or net loss with respect to an “investment services partnership interest” (“ISPI”) as ordinary income or loss
 - ISPI = interest held by a person providing a substantial quantity of investment management services with respect to partnership specified assets (securities, real estate, partnership interests, and commodities)
- Amount characterized as ordinary income or loss is subject to SET

Proposals for Change

- **House Tax Reform Proposals (2013)**

- Option 1: revise rules for S corporations and partnerships
 - Does not address SET
- Option 2: repeal existing rules and replace them with a single set of rules for S corporations and partnerships
 - Would require some rule characterizing distributive share income

Proposals for Change

- **Regulations**

- The AICPA has submitted extensive comments on the proposed and final regulations
 - Rules for income from CFCs and PFICs
 - Section 736 partnership payments
 - Comments on proposed regulations
 - Rules for trusts and estates.
 - Reporting burdens
- Other comments have been submitted and will continue as taxpayers deal with filing returns affected by the NIIT

Questions?

Disclaimer

- **This document is not intended to provide advice on any specific legal matter or factual situation, and should not be relied upon without consultation with qualified professional advisors.**
- **Any tax advice contained in this document and any attachments was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under applicable tax laws, or (ii) promoting, marketing, or recommending to another party any transaction or tax-related matter.**