

# Net Investment Income Tax Final Regulations Released

Nearly a year after release of proposed regulations on the 3.8% net investment income tax imposed by Code section 1411, the IRS has issued final regulations, which adopt (with significant changes) the proposed regulations.<sup>1</sup> In general, the final regulations address many concerns raised in the proposed regulations and adopt positions more taxpayer-friendly than the proposed regulations, especially with respect to rental property.

## General Rules on Net Investment Income Tax

As part of the Patient Protection and Affordable Care Act (commonly known as Obamacare), Congress instituted a new 3.8% tax on "net investment income," which became effective January 1, 2013. This tax applies to individuals, trusts and estates that have net investment income and income over certain statutory threshold amounts. "Net investment income" is generally described in three categories: (1) gross income from interest, dividends, annuities, royalties and rents, other than income derived in the ordinary course of a nonpassive trade or business; (2) income from a passive activity or a trade or business of trading in financial instruments or commodities; and (3) net gain attributable to the disposition of property other than property held in a nonpassive trade or business. For this purpose, a determination of a trade or business as passive or nonpassive is made under Code section 469, which generally requires a taxpayer to "materially participate" in the business to avoid characterization as a passive activity.

## Guidance Under Final Regulations

The final net investment income tax regulations are effective for tax years beginning after December 31, 2013. However, taxpayers may choose to rely on the final regulations in preparing their 2013 income tax returns, which allows taxpayers to take advantage of the significant changes discussed below.

**Self-Rental Property.** The final regulations provide that rental income is deemed derived in the ordinary course of a trade or business if it is treated as nonpassive because of either (1) the self-rental recharacterization rule or (2) appropriate grouping of the rental activity with a trade or business activity. As such, the rental

### POSTED:

Dec 12, 2013

### RELATED PRACTICES:

#### [Tax](#)

<https://www.reinhartlaw.com/practices/tax>

### RELATED PEOPLE:

#### [Lucien A. Beaudry](#)

<https://www.reinhartlaw.com/people/lucien-beaudry>

#### [Michael G. Goller](#)

<https://www.reinhartlaw.com/people/michael-goller>

#### [Sara Stellpflug Rapkin](#)

<https://www.reinhartlaw.com/people/sara-stellpflug-rapkin>

income should not be subject to the 3.8% tax. Further, any gain or loss from the assets associated with the rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

**Real Estate Professionals.** The final regulations contain a safe harbor for real estate professionals. The safe harbor provides that if a real estate professional participates in rental real estate activities for more than 500 hours per year or for more than 500 hours in five of the last ten years, the rental income and any gain or loss from the sale of property is deemed to be derived from the ordinary course of a trade or business. For purposes of the 500-hour requirement, a taxpayer is able to aggregate all rental activities that it has elected to group together pursuant to a grouping election. If a taxpayer does not qualify for this safe harbor, the IRS will consider facts and circumstances to determine if rental income is derived in the ordinary course of a trade or business.

**Self-Charged Interest.** The final regulations provide that, with respect to self-charged interest a taxpayer receives from a nonpassive entity, the individual taxpayer may exclude from net investment income an amount equal to the individual's allocable share of the flow-through entity's deduction related to the loan.

**Net Operating Losses.** In a reversal from the proposed regulations, the final regulations provide that a taxpayer may deduct a portion of a net operating loss deduction in determining net investment income.

## Open Questions

The final regulations address many concerns raised by the proposed regulations, but additional guidance on certain issues has yet to be finalized.

**Gain on Disposition of Partnerships and S Corporation Interests.** The final regulations reject the proposed regulation's calculation of gain or loss on the disposition of interests in partnerships and S corporations. In acknowledging the complexity and burden of the proposed regulations, which required a five-step process, the IRS issued new proposed regulations that provide two methods for calculating gain or loss includible in net investment income—a primary method and an optional simplified reporting method.

**Material Participation by Trusts and Estates.** In response to the proposed regulations, practitioners requested guidance on how to determine material



participation of trusts and estates. The final regulations fail to provide additional guidance, but the IRS has recognized the concern, is studying the issue and may issue further regulations under Code section 469.

## **Regrouping Activities in 2013 May Save on Net Investment Income Tax**

Individual taxpayers who are subject to Code section 1411 are eligible to regroup their activities. Individuals may only regroup activities once under this "fresh start" approach and activities grouped together must comprise an "appropriate economic unit." Regrouping allows taxpayers to convert activities that would fall short of the material participation tests individually to activities that, when grouped together, qualify as nonpassive. Regrouping is not permitted for partnerships or S corporations.

Regrouping can provide a great planning tool for individuals; however, it must be done in this year for taxpayers who qualify.

*These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.*