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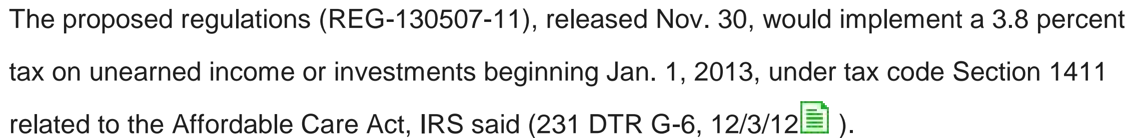
Passthrough Entities

Proposed ACA Rules Incentivize Material Participation for Passthroughs, Experts Say

By ***Lydia Beyoud***

Members of partnerships and S corporations would have greater incentive to actively participate in their businesses in order to establish material participation and avoid a tax on passive income implemented by recently proposed rules from the Internal Revenue Service, practitioners told BNA Dec. 3.

The proposed regulations (REG-130507-11), released Nov. 30, would implement a 3.8 percent tax on unearned income or investments beginning Jan. 1, 2013, under tax code Section 1411 related to the Affordable Care Act, IRS said (231 DTR G-6, 12/3/12).

The proposed rules apply to passthrough entities with individuals or trusts and estates as owners, meaning that virtually all partnerships and S corporations will be affected by the proposed regulations, Michael Grace, managing director, Milbank, Tweed, Hadley & McCloy, told BNA.

Grace characterized the rules as “commendably comprehensive, but complex” due to their intersection with many other provisions of tax law.

“These regulations undoubtedly will increase tax filing complexities because individuals, estates, and trusts now will have to report their net investment income on their own tax returns,” Grace said.

The regulations will also increase compliance work for partnerships and S corporations because starting in 2013 they will have to separately state to their owners on Schedules K-1 their respective shares of the entity's net investment income, Grace said.

Partnerships and S corporations will face increasing complexity under the [proposed] rules in Section 1.1411-7 requiring a “deemed-sale” adjustment on some dispositions of interests in partnerships and S corporations, said Grace.

“Those rules, although somewhat limited in scope, appear complicated,” he said.

The mechanics of the special passthrough entity proposed rules do not simply exempt income for members who materially participate in the underlying business, Steven Schneider, partner, Goulston & Storrs, told BNA.

Instead, if a member sells their interest, the entity must first determine the “inside” gain that would be allocated to the selling member and whether the passive “outside” gain is reduced by the active member's share of the “inside gain,” Schneider said in a Dec. 4 email.

“This complex construct creates the potential for a member with a higher ‘outside' gain than its share of ‘inside' gain to incur the passive income tax even if the member materially participated in 100% of the underlying trade or business,” Schneider said via email.

This section of the proposed rules might catch people off guard, Schneider told BNA.

“The math is going to be a pain,” and because of the inside basis versus outside basis disparity, active members would be required to go through the math, Schneider said.

“It's creating this elaborate look-through [process] you have to go through even though you had a partner that was fully active” in the business, Schneider said.

A Close Intersection With Section 469

The proposed regulations closely intersect with Section 469, passive activity losses and credits limited, Grace said. Grace was the primary author of Section 469 during his time with IRS.

“I think one area of potential confusion will be how to characterize rents,” Grace said. The preamble, but not the regulations themselves, address how Section 1411 intersects with section 469(c)(7), special rules for taxpayers in real property business, Grace said.

The proposed regulations require a taxpayer “to go through a thought process that the statute suggests but that the regulations don't articulate succinctly,” in order to determine whether rents are subject to the tax, Grace said.

“When a client asks, ‘Will my rents be subject to this 3.8 percent surtax, the unsatisfactory answer will have to be, it depends,' ” Grace said by email.

This process requires applying various rules to the regulations in several steps, Grace said. To reach the right answer, one has to determine:

• Are the rents derived in the ordinary course of a trade or business? If not, then they're subject to the 3.8 percent tax.
• If the rents are derived in the ordinary course of a trade or business, then they are also subject to the 3.8 percent tax if that business is a passive activity;
• If not a passive activity, then the rents would escape the tax.

“The regulations don't really articulate it in that step-by-step process,” Grace said.

One way rents could legally escape the tax under the proposed regulations is if a taxpayer qualifies as a “real estate professional” under section 469(c)(7) and if the particular rental activity is not a passive activity, Grace said.

Fresh Start Option Favorable

Because “the enactment of Section 1411 may cause taxpayers to reconsider their previous grouping determinations,” according to IRS, one of the more favorable aspects of the proposed regulations is the proposal to allow partnerships a regrouping “fresh start” under Section 1.469-11(b)(3)(iv), practitioners said.

The regrouping provision in the proposed regulations appeared to be a response to practitioner requests that IRS and Treasury received asking that taxpayers be allowed to regroup their activities in order to meet the material participations rules, Laura Howell-Smith, director of business tax services at Deloitte and a former chair of the AICPA S Corporation Technical Resource Panel, told BNA.

“The grouping motivations can be different in light of the new tax,” Schneider said by email. Taxpayers might have to rethink their activity grouping in a new frame of thought, now taking into account both income as well as losses.

“It's a different thought process, there's something more riding on it now,” Schneider said.

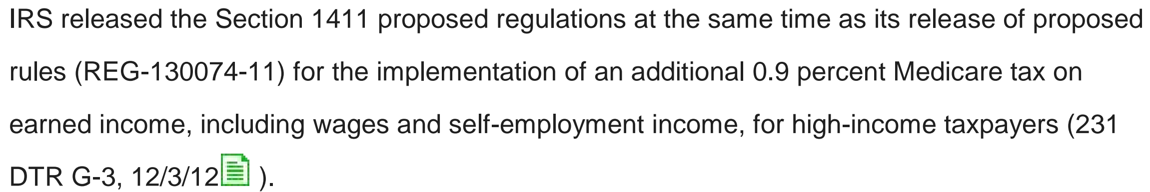
Grace noted that though the proposed regulations' “fresh start” option appears to be a one-time opportunity, there is some ambiguity as to when the regrouping option begins.

“If you read the regulation, it's a little bit confusing because first it says that the taxpayer may regroup in the first taxable year beginning after 2013, but then it goes on to say that a taxpayer may regroup for any tax year during 2013,” Grace said.

Allowing taxpayers to avail themselves of the fresh start option beginning sooner, in 2013, makes sense, because of Section 1411's effective date beginning the same year, Grace said.

"It remains to be seen whether final regulations will grant taxpayers a 'second bite' at the regrouping apple" after the proposed rules are finalized, Grace said in a Dec. 4 email.

Parallel Rules

IRS released the Section 1411 proposed regulations at the same time as its release of proposed rules (REG-130074-11) for the implementation of an additional 0.9 percent Medicare tax on earned income, including wages and self-employment income, for high-income taxpayers (231 DTR G-3, 12/3/12).

It's important to read the two sets of rules in conjunction with one another, because they apply to essentially the same categories of persons, but to different categories of income, Grace said.

"You have to view it as standing at a fork in a road: if you have earned income you apply one set [of rules], and if you have investment income, you apply the other set—but not both [to the same type of income]," Grace said.

Therefore a single taxpayer earning more than $200,000 or a married couple filing jointly and earning more than $250,000 could be subject to both taxes, just on different categories of income, as proposed under the two sets of regulations, said Grace.

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