Final IRS Regulations on Net Investment Income Results in Good News for Farmers in Many Situations

by Paul Neiffer with CliftonLarsonAllen

Background

The net investment income tax is a 3.8% additional tax for individuals with adjusted gross income (AGI) greater than $200,000 ($250,000 for married couples filing jointly). Net investment income for this purpose includes interest, dividends, annuities, rents and royalties, plus passive income from a trade or business activity, the trading in financial instruments and commodities (unless such trading is in the trade or business) and gains from the sales of assets (unless associated with materially participating trade or business income).

IRS Concedes that Self-Rentals and Grouped Rentals are not Investment Income

In the proposed regulations issued by the IRS in December of 2012, commentators were surprised by the inclusion of almost all rental income in the definition of net investment income. These rents included most if not all rental activities even if they had been properly grouped with a material income activity. Under the proposed regulations, the grouped rental income would be considered materially participating income and not subject to the passive activity rules, however, the rent income would still be considered investment income.

After numerous comments from taxpayers and commentators, the IRS had a change of heart. Under final regulations, any rent income that is classified as nonpassive under either of the following provisions will now be considered NOT investment income.

Provision #1: Property rented to a non-passive activity (self-rental income). Rents received by a taxpayer (or a flow-through from an entity) where it is rented for use in a trade or business activity in which the taxpayer materially participates.

Provision #2: Property properly grouped under the provisions of Regs. 1.469-4(d)(1).

Now let’s see how these provisions operate with a few examples:

Example #1: Farmer Bean operates his farm as a sole proprietorship and rents land from Landco LLC owned by him and his wife. The cash rent income flowing through from the LLC is considered non-passive income under provision #1 since it is being rented to his schedule F farm activity and he is a material participant in that farm. It is considered non-passive for both income tax and net investment income tax purposes.
Example #2: Let’s assume that Farmer Bean operates his farm in Farmco, a C corporation. Farmco cash rents farmland owned by Landco LLC. Again, this is self-rental income and considered non-passive for both income tax and net investment income purposes.

Example #3: Now, let's assume that Farmco is an S corporation. It still cash rents farmland from Landco. This is also considered self-rental income and is non-passive. Additionally, Farmer Bean can make an election to properly group Landco and Farmco as one materially participating activity. This makes all income OR loss materially participating and not subject to any passive loss restrictions. It is also not considered net investment income. Unlike Example 2, Farmco cannot make a grouping election as a C corporation even if Farmer Bean materially participates in Farmco.

Any resulting gain from either of these activities will also not be considered investment income. This is a major win for taxpayers. Under the old proposed regulations, in many cases, the sale of farmland that had been properly grouped with a materially participating activity would still be subject to the 3.8% net investment income tax. Under the new final regulations since the rental property was properly grouped with a materially participating activity OR it was self-rental property, none of the gain is subject to the 3.8% tax.

This does add a little bit of complexity to our grouping decisions. Under the passive loss provisions of Sec. 469, it was normally assumed that you might always group a rental activity with its related materially participating activity. This automatically converted any possible rental losses that might not be currently deductible to non-passive losses that would always be deductible.

Now, with the addition of the net investment income tax regulations, there may be cases where a taxpayer may not want to group a self-rental activity. He may want to retain the ability to offset any losses that might arise in the future to offset passive income. This will need to be carefully considered, however, in all cases, the rental income from a self-rental activity will never be subject to the 3.8% net investment income tax.

Final Regulations Provide Further Clarity on Allowed Regrouping Elections

The final regulations also address when a taxpayer can “redo” a grouping election due to the enactment of the net investment income tax. The proposed regulations indicated a taxpayer could have a “do-over” on any grouping election in the first year that the taxpayer 1) met the income threshold requirements and 2) had investment income. Both must be met.

The final regulations retained these same “do-over” provisions; however, they provided additional clarification regarding amended tax returns and examinations. If a taxpayer had properly made a “do-over” regrouping election and it was later determined that adjustments required an amended tax return to either reduce gross income below the threshold level or eliminate investment income, then the taxpayer would be required to undo the regrouping election and be bound by this until both tests applied in the future.

Conversely, if a taxpayer had not made a regrouping election since his income was under the threshold level, but additional income was determined after filing his original return, he would be allowed to make a regrouping election at that time.

When an examination of a taxpayer’s records results in either situation happening as described above, then the taxpayer would be entitled to the same relief or penalty. As examples:

Farmer Bean has schedule F income of $175,000 and interest income of $20,000 for 2013. His total income of $195,000 is under the threshold level; therefore he is not allowed to make any regrouping elections in 2013. It is later determined that $10,000 of additional farm income was not reported on the
original return. When the amended tax return is prepared, Farmer Bean is allowed to make a regrouping election at that time since his gross income is now in excess of the threshold amount. He is then bound by that election on a going-forward basis.

Now, let’s assume that Farmer Bean actually had $185,000 of schedule F income when filing his original return. In this case, he is allowed to make a regrouping election. Later on, he determines that $10,000 of additional farm expenses needs to be reported and when filing his amended tax return, he must reverse his regrouping election and be bound by the original grouping until his income exceeds the threshold level and has investment income again.

Real Estate Professionals Now Have a Safe Harbor

Continuing the rental theme, the final regulations now provide a safe harbor to real estate professionals that may allow them to treat their rental activities as not being subject to the net investment income tax.

Under the proposed regulations, all rental income was considered to be investment income unless it rose to the level of a trade or business. There is no bright-line test for trade or business and many commentators had asked the IRS to provide examples of a bright-line trade or business. The IRS declined, however, with regards to “real estate professionals”; they did throw a safe-harbor lifeline to them that will in most cases, provide the certainty they needed.

First, what is a “real estate professional”? In the original passive activity rules, all rental activities were considered to be passive unless a particular part of the code exempted the rental activity from being passive. Section 469(c)(7)(B) was added later to specifically address a real estate professional.

In order to meet the “real estate professional” provision, you must pass two tests:

**Test # 1:** More than one half of the personal services you perform in all trades or businesses for the tax year must be performed in real estate trades or businesses in which you materially participate (you must spend more hours on real estate than non-real estate activities); and

**Test # 2:** You must perform more than 750 hours of services during the taxable year in real property trades or businesses in which you materially participate. For real estate rental activities, this is an activity-by-activity test, but you may elect to group the rental activities together to pass the test.

Once you qualify as a real estate professional, you may be able to treat real estate rental activities as materially participating activities.

You must pass one of seven tests in order to materially participate in a rental activity (either at the separate or grouped level). These tests are found at Regs. 1.469-5T and in brief are as follows:

1. You participate in the activity for more than 500 hours during the year;
2. Your participation in the activity constitutes substantially all of the participation by all individuals (including non-owners and employees) in the activity for the year;
3. Your participation is more than 100 hours during the year, and no other individual participates more hours than the taxpayer;
4. The activity is a significant participation activity in which you participate for more than 100 hours during the year and your annual participation in all significant participation activities is more than 500 hours. [A significant participation activity is generally a trade or business activity (other than a rental activity) that you participate in for more than 100 hours during the year but do not materially participate in (under any of the materially participation tests other than this test);
5. You materially participated in the activity for any five years (whether or not consecutive) during the 10 immediately preceding tax years;
6. For a personal service activity, you materially participated for any three tax years preceding the current tax year; or

You may want to further group the rental activities together to pass the material participation test.

Here is an example:

Chris owns 12 mini-storage properties. Chris spends 1,500 hours per year managing the properties. While he does not spend more than 500 hours on any one property, he has elected to aggregate all rental activities, thus he materially participates in the combined activity.

Chris spends more than half of his time (1,500 / 2,000 equals 75%) during the year on real estate trade or businesses in which he materially participates. In addition, he spends more than 750 hours in real estate activities in which he materially participated. As a result, Chris qualifies as a real estate professional and the rental activities are no longer passive to him.

Prior to 2013, qualifying as a real estate professional was primarily of importance if the real estate activities were generating losses. Without the election to be a real estate professional, the losses generated by the rental activities would not be available to offset other non-passive income (unless the rental property was sold). If the rental properties were generating income, you were likely not to elect to be a real estate professional since passive income was generally welcomed by most taxpayers.

Roll forward to the 2012 proposed regulations which threw in one more test to exempt real estate professional income from investment income. Under those proposed regulations, it was not enough to 1) qualify as a real estate professional, and 2) materially participate in the rental activity or activities. The proposed regulations added a third test: the rental income must be earned in the ordinary course of a trade or business.

This added test would be extremely difficult for almost all real estate professionals to meet. Accordingly, the IRS relaxed the rules in the final regulations and provided a safe-harbor provision that would allow the real estate professional to report rental income as not being investment income.

This safe-harbor provides that, if a real estate professional participates in a rental real estate activity for more than 500 hours per year – or for more than 500 hours in five of the last ten years – then the rental income associated with that activity will be presumed to be derived in the ordinary course of a trade or business.

Most real estate professionals do not spend 500 hours on each rental activity, but the IRS actually enhanced the safe-harbor provision by stating that any election under Regs. 1.469-9 aggregating rental activities will be respected for purposes of the 500 hour rule. An example is probably much easier to understand than the verbiage:

Chris has elected to group all 12 of his mini-storages as one activity. Even though he spends less than 500 hours on any mini-storage property, since he has elected to aggregate all 12, his 1,500 hours of combined management will qualify him as a real estate professional.

For investment income tax purposes, since in aggregate, he spends more than 500 hours on these rental activities, then this income is not considered passive and not subject to the net investment income tax.

There are cases where real estate professionals will not meet the safe-harbor provisions. This is usually the case of taxpayers who have substantial real estate services and do not spend more than 500 hours on rental activities. As an example:
Assume Chris is a real estate broker and owns 4 single family residences that he spends at least 100 hours on each year. He has qualified as a real estate professional and for income tax purposes, any losses are treated as non-passive and fully deductible. However, since he does not spend more than 500 hours on the rentals (even if grouped together), any net rental income will be subject to the tax.

This is a safe-harbor provision. Taxpayers are still allowed to argue that their real estate professional activities rise to the level of a trade or business which would allow the income to be excluded from the 3.8% net investment income tax. However, care must be taken since if the taxpayer is too successful in this argument, most IRS agents would likely try to assess self-employment tax on this rental income which may result in even greater tax.

### Net Losses Are Now Allowed to Offset Other Investment Income

Under the proposed regulations, losses from the sale of assets could only be used to offset gains from the sale of assets. If a net loss resulted after netting gains and losses, for net investment income tax purposes, the loss was essentially worthless.

The final regulations essentially retained the same language of the original proposed regulations regarding limiting net losses to zero, however, it added Regs. 1.1411-4(d)(2) allowing the net capital loss deduction of $3,000 to be allowed to offset other investment income. For individuals, net capital losses for any year are limited to: 1) offsetting other capital gains; or 2) $3,000, whichever is less. Any amount of net capital losses in excess of $3,000 are carried forward to future years. As an example:

**Farmer Bean sells IBM stock for a $15,000 loss which also generated $5,000 of dividend income during the year. He has no other gains or losses or investment income for the year, therefore, he is allowed to deduct $3,000 of the capital losses against other income. For investment income purposes, his net investment income is $2,000 ($5,000 of dividend income less the $3,000 capital loss allowed).**

Now, $3,000 can be a nice deduction to have; however, in many cases, taxpayers will have losses substantially higher than this amount and under the old proposed regulations, these deductions would be limited to zero. The final regulations add new Regs. 1.1411-4(f)(4) which essentially states that any losses in excess of gains may now be used to offset other types of net investment income, but only to the extent the losses are used to currently reduce the taxpayer’s taxable income. This does not mean you can create a net loss; however, what you can do is take any excess losses that exceed net gains, and if they are currently allowable in determining taxable income, use them to reduce other items of net investment income. A few examples may clear this up:

**Farmer Bean incurs a long-term capital loss of $25,000 from the sale of Microsoft, has $50,000 of interest and dividend income and has a gain of $35,000 from the sale of some farm property. Under Section 1231, this gain is treated as a long-term capital gain and will offset the $25,000 Microsoft loss for net capital gains of $10,000.**

Under the proposed regulations, the $35,000 gain would not be considered investment income since it is from the sale of farm property used in a business. Because Farmer Bean’s investment gains cannot be below zero, the Microsoft loss of $25,000 is not allowed to offset any other investment income, thus under the old proposed regulations, net investment income equals $50,000.

Under the final regulations, the $35,000 of gain would still not be included in net investment income because the same exceptions are met.

For income tax purposes, Farmer Bean is allowed to offset the $35,000 gain with the $25,000 loss and only report a net gain of $10,000. Under the final regulations at Regs. 1.1411-4(f)(4), because the $25,000 Microsoft loss was allowed to reduce taxable income, the loss may be used to offset Farmer
Bean’s other investment income. In this case, his net investment income subject to the 3.8% tax is now $25,000, not $50,000 or a savings of $950.

So even though we cannot generate a net loss from sale of property, this new rules allows us to essentially get the same result in most cases.

Under the old proposed regulations taxpayers with large Section 1231 passive losses may have had negative consequences in calculating their net investment income. As an example:

Farmer Bean has invested in an Ethanol plant in the next state. This is a purely a passive investment and in most years it generates $100,000 of passive income. However, for 2013, in addition to the $100,000 of passive ordinary income, the Ethanol plant sold some assets for a net Section 1231 loss of $100,000.

For income tax purposes, Farmer Bean is allowed to offset the $100,000 of Section 1231 losses against his $100,000 passive income for net taxable income from the investment of zero.

Under the old proposed regulations, this net Section 1231 loss would most likely not be allowed and Farmer Bean would owe the 3.8% investment income tax on the Ethanol passive income or $3,800 of additional tax.

Under the new final regulations, since the Section 1231 loss is allowed to offset passive income, the Section 1231 loss is allowed in full to offset all investment income for a savings of $3,800.

Net Operating Losses Can Now Partially Offset Investment Income

The proposed regulations provided that, in no event, will a net operating loss deduction (NOL) allowed under Section 172 be taken into account in determining net investment income for any taxable year. Many commentators had argued that at least part of a net operating loss should be allowed to offset investment income since at least some portion of a net operating loss may have a component of investment income.

Three commentators recommended that the taxpayers be allowed to keep track of the investment portion of an NOL on a year-by-year basis. One commentator encouraged the IRS to adopt a simple rule for determining the portion of an NOL attributable to net investment loss for a loss year.

The final regulations adopt a modified version of the commentator’s approach in Regs. 1.1411-(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by-year, a separate ratio must be determined for each year. The portion of an NOL deduction for a taxable year that may be deducted against investment income is calculated by first determining the applicable portion of the NOL for each loss year.

Essentially, the taxpayer will determine two NOL for any loss year. The regular NOL computed under Section 172 is determined. Second, the NOL that arises only from investment sources is then determined. This NOL is then divided into the regular NOL to arrive at a factor for that loss year. These examples are extremely long in the final regulations but I will try to summarize one here:

Assume Farmer Bean has a bad year and based upon the calculations under Section 172, his NOL for the year is $400,000 and his “investment” portion of the NOL is $100,000. His investment NOL factor for this loss year is 25%.

He elects to carryforward the NOL to 2014 when he has a much better year. He realizes farm income of $600,000 and has interest and dividend income of $150,000. The $400,000 NOL is allowed as a deduction reducing his gross income to $350,000. His investment income is comprised of the $150,000 of
interest and dividends less $100,000 (the $400,000 NOL actually allowed times a factor of 25%). This results in net investment income of $50,000.

Relief for Self-Charged Interest Income

The original proposed regulations had not considered excluding self-charged interest income from the investment income. Several commentators noted that, under the proposed regulations, a taxpayer who is not in the trade or business of lending would have net investment income when it receives interest income attributable to a loan made to a pass-through entity in which he materially participates. A situation similar to this was identified during the 1986 enactment of Section 469, which resulted in the promulgation of the self-charged interest rules in Regs. 1.469-7.

In response, the final regulations include a special rule that addresses self-charged interest. It provides that in the case of self-charged interest received from a non-passive entity, the amount of interest income excluded from net investment income will be the taxpayer’s allocable share of the non-passive deduction. It cross references to Regs. 1.469-7 for computational purposes. As an example:

Farmer Bean owns 90% of Farmco, Inc., an S corporation in which he materially participates. During the year, he lends the corporation $300,000 and receives $20,000 of interest income. Since he owns 90% of Farmco, $18,000 of the $20,000 interest received is excluded from investment income and he only reports $2,000 of interest income as investment income.

If the self-charged interest was deducted in arriving at self-employment income at the entity level, then all of that self-charged interest will be treated as investment income. Here is an example:

Farmer Bean is a material participant in HogBarn LLC. During 2013, Farmer Bean loaned the LLC $300,000 and received $20,000 of interest income. Since the interest paid by the LLC reduces the self-employment income of the LLC, Farmer Bean is required to report all $20,000 of interest income as investment income.
New Proposed Regulations Provide for Simplified Calculations for Sale of Partnership and S Corporation Interests

On Tuesday, November 26, the IRS issued Final Regulations regarding the imposition of the net investment income tax under Section 1411. These Final Regulations replaced the Proposed Regulations issued late in 2012. In addition, due to comments from taxpayers, the IRS also issued new Proposed Regulations dealing with certain interpretations of the net investment income tax relating to the calculation of investment gain from the sale of an interest in a partnership or S corporation.

Old Proposed Regulations: Complex Calculations of Investment Gain From the Sale of Partnership and S Corporation Interests

Under the proposed regulations issued in December 2012, the sale of a partnership interest or stock in an S corporation would generally be included in net investment income since it was the sale of property. However, the proposed regulations provided certain exclusions for owners of these pass-through entities based upon the amount of gain or loss related to trade or business assets in which the taxpayer materially participated. The computation would need to be made each time a person sold an interest or realized a gain in a pass-through entity, if that person materially participated in an activity of the entity. If the taxpayer was a passive investor, no separate computations were necessary; all gain was subject to the net investment income tax.

The IRS received numerous complaints about the complexity of these proposed regulations and in response added new proposed regulations under Regs. 1.1411-7 to simplify this process for most taxpayers.

New Proposed Regulations: Inclusion Instead of Exclusion and an Optional Simplified Reporting Method

This unintended consequence and the related complexity of these rules caused the IRS to issue new proposed regulations. These new regulations offer a shortcut that should eliminate this complexity in nearly all cases, especially for farmers selling a farm S corporation or partnership.

Instead of taking the total gain and trying to “exclude” the amount of gain not related to investment income, the new proposed regulations now only require taxpayers to calculate the amount of gain to be “included.” Under this approach, it will now eliminate the possibility of having to include gain as investment income when the taxpayer’s outside basis is lower than the entity’s basis in its assets. Second, it now offers a shortcut for certain qualifying taxpayers that should greatly simplify this process.

The new formula provides that the amount of gain or loss from selling an interest in an S corporation or partnership is now simply the lesser of:

1. The seller’s overall gain or loss on the sale of the partnership interest or stock in an S corporation; or
2. The seller’s share of the hypothetical gain that would be included in net investment income because assets were not used in the trade or business or the activity was passive to the seller.

Let’s review this in the context of our Farmer John example:

Farmer John sells his 90% interest in Farco, Inc., an S corporation in which he materially participates. Farmco owns marketable securities with a cost basis of $100,000 and fair market value of $150,000. This results in a hypothetical gain on the sale of these securities of $50,000 and Farmer John’s 90% share of $45,000 would now be included as investment income. Therefore, $355,000 of the $400,000 gain is still excluded from investment income, while $45,000 is now included.
This still requires a calculation of the hypothetical gain or loss on the activities and assets of the sold pass-through entity. To simplify this process for most taxpayers, the IRS has now proposed a shortcut. If the seller of a partnership interest or stock in an S corporation qualifies, he or she may now use an “optional simplified reporting” method.

To qualify, the seller must satisfy at least one of two tests:

**Test # 1:** The taxpayer must satisfy BOTH of these requirements:

1. The cumulative sum of net investment income allocated to the seller in the year of sale plus the two preceding years (note, losses must be added as a positive number) must be less than 5% of the sum of all items of income, gain, loss and deductions allocated to seller during that period (again with any losses and deductions included as a positive number); AND

2. The total amount of gain recognized on the sale of the interest must be less than $5 million.

**Test # 2:** The total amount of gain recognized on the sale of the interest must be less than $250,000.

In other words, if your gain is $250,000 or less, then you can use the shortcut. If you gain is more than $250,000 and less than $5 million, you must check your allocated income over the current year plus the last two years to see if you qualify. Let’s look at an example:

Farmer John still sells his Farmco stock for a $400,000 gain. Since this gain is greater than $250,000, he must then review his allocated items of income and loss over the current year and the previous two years. These items are as follows:

- **Farm Income** - $1,500,000
- **Interest Income** - $25,000
- **Passive Loss** - $(10,000)

In order for Farmer John to use the simplified method, his total allocated investment income items must be less than 5%. Let’s do the math in this example.

Over the three year period, Farmer John was allocated $35,000 of items that constitute net investment items: ($10,000 of passive losses and $25,000 of interest income). Notice that the $10,000 loss is counted as a positive number since we are trying to determine the overall ratio of net investment income-type allocations to total allocations.

The total amount of allocated income during the three-year period is $1,535,000. Thus, $35,000/$1,535,000 is less than 5% and therefore Farmer John can use the optional simplified method.

Now that we have determined that we can use the optional simplified method, we must now calculate the amount that must be included in investment income. To accomplish this, we must multiply the amount of gain from the sale of the interest by the following fraction:

- The sum of all net investment income or loss allocated to the seller over the current year plus the last two years (this time, with any losses counted as a negative number and offsetting the income) OVER
- The sum of all items allocated to the seller during that same period.
Going back to our Farmer John example, since he can use the optional simplified method, he can skip the deemed sale of assets calculation and simply calculate the required percentage as follows:

- $15,000 ($25,000 of interest income less the $10,000 passive loss) OVER
- $1,515,000 (the cumulative income and loss during the period).

As a result, Farmer John is required to include .00990099 of his $400,000 gain or $3,960.40 as investment income.

Although this is considered a shortcut by the IRS, it still requires the taxpayer or his tax advisor to have on hand three years of schedules K-1 and be able to determine which items of allocated income on the K-1 is actually investment income. Additionally, the math can be confusing since a loss is a positive number for purposes of the 5% test, but a negative number for purposes of computing the actual amount of gain included as investment income.

For installment sales, the proposed regulations now require two separate calculations. First, the normal installment rules will still apply for determining the amount of gain subject to income taxation. However, since gain from a sale of an interest is now only included as investment income, any excluded gain is now added to the basis of the asset being sold. This additional basis is only for purposes of determining the amount of gain to be included as investment income each year. Thus, two separate installment sale schedules will be required.

Here is an example of how we think it will work (since there is no example in the Regulations):

Assume Farmer Bean sells Farmco for $900,000 with a basis of $500,000 resulting in a $400,000 gain. He sells the stock for $100,000 down with the remainder paid in 10 equal annual principal payments of $80,000 plus interest. Let’s assume that $200,000 of this gain must be included as investment income. This means that $200,000 is “excluded gain” ($400,000 total gain less $200,000 “included gain”).

Farmer John must increase his basis from $500,000 to $700,000 for purposes of the net investment income tax which results in a gross profit percentage of 22.222%. Thus, in the year of sale, $22,222.22 is included as investment income and each year thereafter, $17,777.77 would be excluded.

To make sure that the taxpayer is calculating these numbers correctly, the IRS will require in the year of sale the following information:

- The name and taxpayer identification number of the entity in which the interest was transferred;
- The amount of the seller’s gain or loss on the disposition of the interest;
- The information provided to the seller by the pass-through entity in order to compute the deemed asset sale calculation;
- The amount of adjustment to gain or loss by reason of paragraph (f) of the proposed regulations, if any (these adjustments will not apply to most taxpayers).

All-in-all, the new proposed regulations are an upgrade from the old proposed regulations for dealing with the amount of gain from the sale of a partnership or S corporation interest that will be subject to the net investment income tax. For most farmers, the “optional simplified method” will save time and effort in calculating this gain and if your gain is less than $250,000, you will automatically be allowed to use this method.