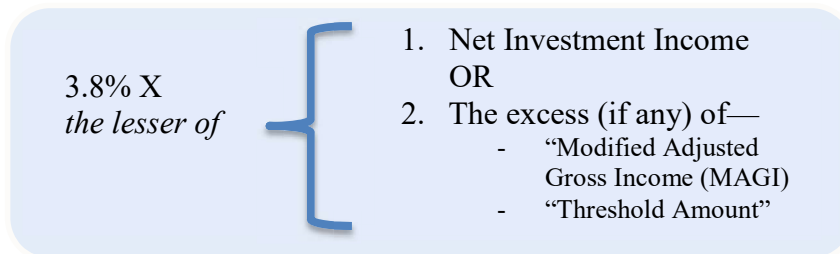


## #18: Grouping Business Activities to Create Material Participation and Avoid the NIIT

IRC § 469 provides that losses from passive activities can only be deducted against passive income and not against non-passive income like wages, capital gains, dividends and interest. Prior to 2013, planning under the passive loss rules involved (1) creating passive income to offset passive losses, and (2) creating non-passive losses that could be used to offset either passive or non-passive income. After enactment of the NIIT, however, passive loss planning might be quite different. While non-passive losses are still desirable, taxpayers will often be better off avoiding passive income because it will generally be subject to the NIIT.

For individuals, the amount subject to the NIIT is the lesser of (1) net investment income (NII), or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount based on filing status.<sup>57</sup>



Net investment income (NII) includes not only interest, dividends, annuities, royalties and rents, but also income and net gain from a trade or business that is a passive activity with respect to the taxpayer.

### Activity Grouping Rules--Background

To avoid the passive loss rules with respect to a business activity, a taxpayer must materially participate in the activity. To establish material participation, the taxpayer must satisfy one or more of the seven tests listed at Reg. § 1.469-5T. These are generally quantitative tests that require a taxpayer to participate for a specified number of hours in the activity. Under the most frequently used test, the taxpayer must have more than 500 hours of participation. Because these material participation tests are applied at the activity level, taxpayers may be able to combine more than one operation into a single activity to achieve the requisite hours of participation needed to make the activity non-passive.<sup>58</sup> As a general rule, the more operations the taxpayer can combine, the more likely it is that the taxpayer will have met one of the material participation tests.

Activities can be grouped into a single activity if they constitute an appropriate economic unit for measuring gains and losses under IRC § 469, taking into account all the facts and circumstances. The most important factors to consider are:

<sup>57</sup> The ATAs are \$200,000 for single taxpayers, \$250,000 for married taxpayers filing jointly and \$125,000 for married taxpayers filing separately.

<sup>58</sup> Reg. § 1.469-4(c)(1).

- (1) Similarities and differences in types of trades or businesses;
- (2) The extent of common control;
- (3) The extent of common ownership;
- (4) Geographical location; and
- (5) Interdependencies between or among the activities.<sup>59</sup>

While taxpayers have considerable flexibility in deciding how to group activities, there are some important limitations:

- (1) A rental activity can only be grouped with a trade or business activity if the activities being grouped together constitute an appropriate economic unit and--
  1. The rental activity is insubstantial in relation to the trade or business activity;
  2. The trade or business activity is insubstantial in relation to the rental activity;or
  3. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.<sup>60</sup>
- (2) Real property rental activities cannot be grouped with personal property rental activities.<sup>61</sup>
- (3) The following activities cannot be grouped with any other activity:
  1. Holding, producing, or distributing motion pictures;
  2. Farming;
  3. Leasing an IRC § 1245 property;
  4. Exploring for, or exploiting oil and gas resources; and
  5. Exploring for, or exploiting geothermal deposits.<sup>62</sup>

### **Special Planning Opportunity**

Taxpayers generally have only one chance to group activities. Once made, the grouping election ordinarily cannot be changed.<sup>63</sup> The final regulations for implementing the NIIT include a special fresh start provision, however, that allows taxpayers to regroup activities in the first year the taxpayer is subject to the NIIT. Only one regrouping is allowed, and once made, the regrouping applies to all subsequent years.<sup>64</sup>

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<sup>59</sup> Reg. § 1.469-4(c)(2)(i)-(v).

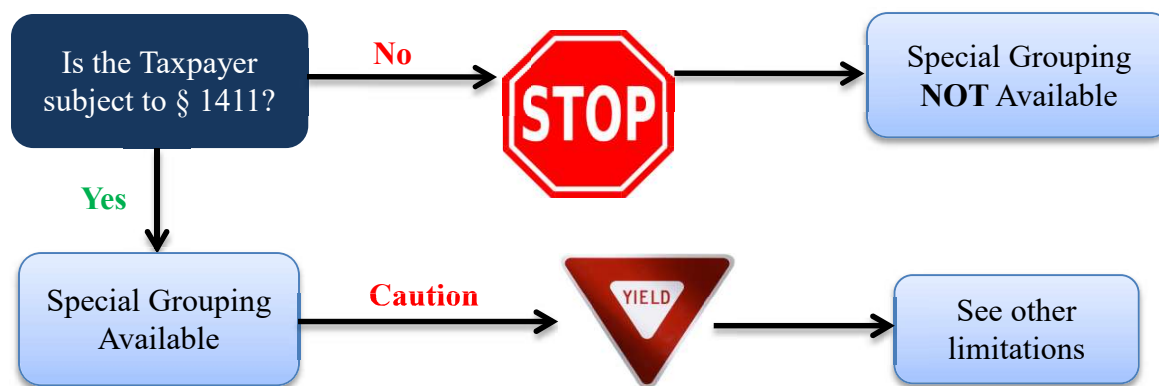
<sup>60</sup> Reg. § 1.469-4(d)(1)(i).

<sup>61</sup> Reg. § 1.469-4(d)(2).

<sup>62</sup> Reg. § 1.469-4(c).

<sup>63</sup> Reg. § 1.469-4(e)(1).

<sup>64</sup> Reg. § 1.469-11(b)(3)(iv).



Given the changed planning objectives following the effective date of the NIIT, this provision may be helpful for many taxpayers. Consider the following example.

**Example 1.** Sally owns a restaurant and a bakery. She participates approximately 1,200 hours in the restaurant, but only about 200 hours in the bakery. Both businesses have several other employees who work full time. Before 2013, Sally did not group the two businesses, treating them as separate activities. Thus, she was treated as materially participating in the restaurant, but not in the bakery. If Sally does not exercise the special regrouping election, the income from the bakery will be treated as net investment income and may be subject to the 3.8% NIIT. If Sally is first subject to the NIIT in the current year, she may be able to combine the restaurant and the bakery into one activity so that she can be treated as materially participating in both, and avoid the NIIT on the bakery income.

Furthermore, rental activities can be grouped with other activities under limited circumstances; and, therefore, the rental income in those limited circumstances will not be treated as NII. The limited circumstances provided by the Final Regulations under the NIIT are for certain self-rental activities and real estate professional activities. Self-rental income will not be treated as NII if the rental income is treated as non-passive by reason of Reg. § 1.469-2(f)(6) (which recharacterizes what otherwise would be passive rental income from a taxpayer’s property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under Reg. § 1.469-4(d)(1) and the grouped activity is a non-passive activity.<sup>65</sup>

If the taxpayer qualifies as a real estate professional (as defined in § 469(c)(7)) and the real estate activities constitute a “trade or business,” then the activities will be treated as nonpassive, and thus, not subject to the NIIT. There are two ways for the real estate activities of a real estate professional to constitute a “trade or business:” 1) fall under the safe harbor as provided for in the Final Regulations; or 2) meet the definition of a “trade or business” under § 162. A real estate professional qualifies for the safe harbor if: 1) they participate more than 500 hours per year in the real estate activities, or 2) participated more than 500 hours annually in the real estate activities in the past five out of ten years. An election to treat all rental real estate as a single rental activity under Reg. § 1.469-9(g) is allowed under this test.<sup>66</sup>

<sup>65</sup> See Reg. § 1.1411-4(g)(6).

<sup>66</sup> See Reg. § 1.1411-4(g)(7).