

Grouping Elections and the Net Investment Income Tax *(Medicare Surtax)*

Tax
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This article addresses rules for identifying Net Investment Income for tax purposes as they relate to an owner of multiples entities where the owner materially participates in one or more of the entities, has self-rental entities, and does not materially participate in other entities.

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The Net Investment Income (NII) tax imposes a rate of 3.8 percent on the lesser of two amounts: the NII, or the amount that adjusted gross income exceeds certain thresholds. NII generally includes, among other things, rental income not derived from a trade or business and income from passive activities. At first blush, the income from the self-rental activities and the activities in which the owner does not materially participate can appear to be NII, but the NII tax can potentially be avoided on both sources of income.

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SELF-RENTAL INCOME

Although rental income is generally passive and thereby included in NII, income from self-rental activity is considered under regulations as non-passive. In addition, regulations provide that self-rental income will be considered derived from a trade or business. Thus, the owner's allocable share of self-rental income will be both non-passive and derived from a trade or business, thereby avoiding treatment as NII. As well as:

- Grouping the self-rental activities with business activity in which the owner is an active participant is not required to avoid the NII tax.
- Rental income from a self-rental activity that had previously been grouped with the business activity also avoids inclusion as NII.
- Interest income generated by the self-rental activity is included as NII.

PASSIVE ENTITIES

If the owner does not materially participate in the business activity and no action is taken, the allocable share of the passive entity's ordinary business income is included as NII. However, grouping the passive activity with the non-passive activity effectively converts it into a non-passive activity and thereby avoids including it as NII. Interest, dividends, capital gains/losses generated by the passive activity will continue to be included as NII. In order for one activity to be grouped with another, the resulting group must comprise an appropriate economic unit (AEU). The AEU rule for grouping is a facts-and-circumstances inquiry, which is determined by key factors:

- Similarities and differences in types of trades or businesses
- Extent of common control

Once a taxpayer chooses to group or not group a set of activities, the same grouping must continue unless there is a material change in the facts or circumstances or it is determined that the original grouping was clearly inappropriate.

- Extent of common ownership
- Geographical locations
- Interdependencies between or among the activities

It is essential to evaluate the factors to determine whether the passive and non-passive activities represent an AEU. If they do not represent an AEU, the grouping election will not be honored and the ordinary income from the passive activity will be included in the NII of its owner. If given the factors that the entities do represent an AEU, grouping will be appropriate. In addition, because the ability to group is a function of only the passive activity rules, the grouping of passive and non-passive activity should not serve to increase the owner's self-employment income.

ELECTION TO GROUP ACTIVITIES

Historically, taxpayers have been permitted to group an activity for the year in which it is acquired. In addition, taxpayers have been allowed to group or re-group an activity if there is a material change in the facts or circumstances, or it is determined that the original grouping was inappropriate. Some believe that an election not to group is itself a grouping election. Therefore, once a taxpayer chooses to group or not group a set of activities, the same grouping must continue unless there is a material change in the facts or circumstances or it is determined that the original grouping was clearly inappropriate.

The regulations provide that the presence of the NII tax will constitute a material change in facts or circumstances that will allow a taxpayer to group or re-group activities for the first year beginning after December 31, 2013, in which the taxpayer is subject to the NII tax.

TAX RETURN DISCLOSURE

Revenue Procedure 2010-13 prescribes certain tax return disclosure requirements for electing to group or re-group activities. There is no separate election form issued by the IRS. Rather, the grouping election is made in a statement accompanying the taxpayer's return.



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