

Passive vs. Active: Net Investment Income Tax Implications for S-Corporation Bank Shareholders

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Shareholders in S-corporation financial institutions increasingly have been faced with the net investment income tax (NIIT) created by the *Patient Protection and Affordable Care Act*. Yet many of these shareholders remain unaware of the applicable rules, documentation issues, and planning opportunities. In particular, S-corp shareholders need to understand how the treatment of pass-through income and loss can affect their NIIT liability.



The Interplay Between Passive Activities and the NIIT

The NIIT, which first took effect for the 2013 tax year, is a 3.8 percent tax on net investment income. Net investment income generally includes investment income – such as capital gains, interest, dividends, rent, and royalties – unless it's derived in the ordinary course of a trade or business that isn't passive under IRC Section 469. Any income from a passive trade or business activity is net investment income. Thus, an S-corp shareholder generally will include all income from the corporation in his or her net investment income if the corporation is a passive activity for the shareholder.

The Material Participation Issue

The regulations for Section 469 generally provide that an activity isn't passive if the taxpayer "materially participates" in the activity on a regular, continuous, and substantial basis. A taxpayer can establish material participation under any of the following seven tests:

1. Does the taxpayer or spouse work more than 500 hours per year in the business?
2. Does the taxpayer do most of the work?
3. Does the taxpayer work more than 100 hours per year and no one (including nonowners or employees) works more hours?

4. Does the taxpayer have several passive activities in which he or she participates 100-500 hours each, and the total time is more than 500 hours annually?
5. Did the taxpayer materially participate in the activity for any five of the 10 preceding years?
6. Did the taxpayer materially participate in a personal service activity for any of the three prior years?
7. Do the facts and circumstances indicate the taxpayer is materially participating?

The latter, subjective test does not apply unless the taxpayer worked more than 100 hours per year. It also does not apply if any person other than the taxpayer received compensation for managing the activity, or if any person spent more hours than the taxpayer managing the activity.

The test related to material participation in five of the previous 10 years is particularly important when a bank is being sold. Even if a shareholder isn't participating materially in the bank when the sale occurs, the gain from the sale won't be subject to the NIIT if the shareholder materially participated in any five of the preceding 10 years. Proper planning is critical to avoid the NIIT in this situation.

Disqualified Activities

Certain "disqualified activities" cannot be counted toward material participation. Work not customarily performed by owners is disallowed if the principal purpose of the work is to meet the material participation rules (for example, having a spouse work as a receptionist solely to increase the hours of participation).

Investor activities also are disallowed unless the taxpayer is directly involved in day-to-day management or operations. Investor activities include:

- Studying and reviewing financial statements or reports on activity operations
- Preparing or compiling summaries or analyses of finances or operations for the individual's own use
- Monitoring finances or operations in a nonmanagerial capacity

Grouping Activities and Regrouping Election

Section 469 offers taxpayers the ability to treat one or more trade or business activities as a single activity if the activities are an "appropriate economic unit" based on all relevant facts and circumstances. Consideration of these detailed rules are beyond the scope of this article, but should be evaluated further to determine the appropriate course of action.



Tax Distribution Considerations

If an S corporation intends for its tax distributions to shareholders to cover the NIIT, it should first review the shareholder agreements to determine if this is permissible. Assuming the agreements allow NIIT distributions, disproportionate distributions still are not allowed. Therefore, even shareholders who aren't subject to the NIIT on S-corp income must receive the increased tax distribution amount.

Plan Carefully, and Document, Document, Document

The interaction of the passive activity rules and the NIIT offers a number of challenges for shareholders in S corporations (especially if a sale is contemplated) that add yet another layer to S corporations' tax planning. Documentation detailing day-to-day activities is critical in substantiating a position taken in a tax return. Do not assume that the details of such activities will be easy to recall two to three years after the fact.



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