Hot Topics
Chapter 2
IRC sec. 1411 and Final Regulations
§1411 -- Imposition of tax

Reg. § 1.1411-0: Table of contents of provisions applicable to section 1411.

Reg. § 1.1411-1: General rules.

Reg. § 1.1411-2: Application to individuals.

Reg. § 1.1411-3: Application to estates and trusts.

Reg. § 1.1411-4: Definition of net investment income.

Reg. § 1.1411-5: Trades or businesses to which tax applies.

Reg. § 1.1411-6: Income on investment of working capital subject to tax.

Reg. § 1.1411-7 [Reserved. Exception for dispositions of interests in partnerships and S corporations.]

Reg. § 1.1411-8: Exception for distributions from qualified plans.

Reg. § 1.1411-9: Exception for self-employment income.

Reg. § 1.1411-10: Controlled foreign corporations and passive foreign investment companies.

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### Investment Income (before deductions)

<table>
<thead>
<tr>
<th>Category One</th>
<th>Gross Income – Interest, Dividends, Annuities, Royalties, and Rents that are:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Nonbusiness (investment)</td>
</tr>
<tr>
<td></td>
<td>• Passive business income</td>
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<tr>
<td></td>
<td>• Trading business income</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category Two</th>
<th>Other Gross Income that is:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Passive business income or</td>
</tr>
<tr>
<td></td>
<td>• Trading business income</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category Three</th>
<th>Net Gain from the disposition of property that:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Nonbusiness (invest. or personal)</td>
</tr>
<tr>
<td></td>
<td>• Passive business</td>
</tr>
<tr>
<td></td>
<td>• Trading business</td>
</tr>
</tbody>
</table>
Final 2013 K-1

<table>
<thead>
<tr>
<th>Box 20</th>
<th>Other Information</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</table>

Y Net Investment Income
What's New

- **Schedule K-1 (Form 1065).** New code Y has been added to box 20 of Schedule K-1. Code Y is used to report information related to the net investment income tax. Former Code Y (Other information) is now code Z.

- **Regulations section 1.1411-10(g) election.** The partnership can elect to include section 951 inclusions and section 1293 inclusions in net investment income for purposes of section 1411 in the same tax year as the amounts are included in income for chapter 1 purposes. See Regulations section 1.1411–10(g) under Elections Made by the Partnership for more information.

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**Net investment income (code Y).** Use code Y to report any information that may be relevant for partners to compute their net investment income tax when the information is not otherwise identifiable elsewhere on Schedule K-1. Attach a statement that shows a description and dollar amount of each relevant item.

Examples of items reported using code Y may include the following.

- Net rental real estate income reported on Form 1065, Schedule K, line 2, and other net rental income reported on Form 1065, Schedule K, line 3c, derived from a section 212 for-profit activity (and not from a section 162 trade or business).
• Gains and Losses from dispositions of assets attributable to a section 212 for-profit activity (and not from a section 162 trade or business). **NII even if other 162 businesses**
• Gain reported on the installment sale basis (or attributable to a private annuity) that is attributable to the disposition of property held in a trade or business. **Not NII if nonpassive**
• Gain or loss from the disposition of a partnership interest, but only if such partnership was engaged, directly or indirectly, in one or more trades or businesses, and at least one of those trades or businesses was not trading in financial instruments or commodities. **Not NII if nonpassive**

• The partner’s distributive share of interest income, or interest expense, which is attributable to a loan between the partnership and the partner (self-charged interest). **Generally excluded from NII**
• If the partnership received a Form 1065, Schedule K-1, the detail and amounts reported to the partnership on code Y.
• If the partnership received a Form 1065-B, Schedule K-1, the detail and amounts reported to the partnership.
• If the partnership received a Form 1041, Schedule K-1, the amount of the adjustment reported.
• Guaranteed payments (reported on Form 1065, Schedule K, line 4) unrelated to services, such as for the use of capital or attributable to section 736(a)(2) payments for unrealized receivables or goodwill.

• In the case of a common item of income or loss that is not taken into account in computing net investment income (other than dividends, and short-term and long-term capital gains).

In addition, Regulations section 1.1411-10 provides special rules with respect to stock of CFCs and PFICs owned by the partnership. If the partnership owns directly or indirectly stock of a CFC or PFIC, then additional reporting may be required under code Y.

**Guaranteed payments for use of capital are Nil unless subject to SE tax**
Interest income on loan to passthrough entity in which the lender materially participates.

(Reg. 1.1411-5(g)(5))

• Example: LLC member Alice, a 40% partner, loans $100,000 to the LLC partnership.

• She materially participates in the php.
NII exclusion is limited to Alice’s 40% share of the nonpassive interest deduction
No relief if the interest deduction reduces **SE tax.**

Ex: General Ptr loans..

**Relief for Self-Rentals**

*(Reg. sec. 1.1411-4(g)(6))*
Gross rent is excluded from NII if:

1) Rental income treated as nonpassive by reason of Reg. 1.469-2(f)(6).

Deemed T or B even if a net lease

“-2(f)(6) An amount of the taxpayer's gross rental activity income ... from an item of property equal to the net rental activity income ... from that item of property is treated as [nonpassive] if the property -- (i) Is rented for use in a trade or business activity * * * in which the taxpayer materially participates.”
Debbie is a 5% Partner

Debbie is a C corp Shareholder
Gross rent is excluded from NII if:

2) nonpassive business income as a result of Reg. 1.469-4(d)(1) grouping of the rental with a nonrental T or B activity

GROUP AS ONE BUSINESS ACTIVITY

CPA Debbie

100%

Materially Participates

RENT Profitable Nonpassive Activity Escapes NII

S CORP Business
Why Bother To Group Given Generous Self-Rental Rule?

GROUP AS ONE BUSINESS ACTIVITY

CPA Debbie 100%

Materially Participates

S CORP Business

RENT

Nonpassive Losses

Lost
The self-rental relief also applies to sale gain

Consider one-shot regrouping election
Regrouping in Final Regs.

• Can regroup in first post-2012 year in which NII applies.

• Optional in 2013.

• No regrouping allowed for Phps and S corps.

• Can regroup on amended return if prior year becomes subject to NII.
Focus on Limited Partner (LP) Y

- 99% Limited Partner
- Zero Hours

No SE Income
NII-Passive

SE Income
No NII-SE & Nonpassive

What if:
Limited Partner Y also owns a controlling interest in a grocery store partnership that Y participates in for 1000 hours
In prior years, Y did not bother to group the XYZ LP interest, because it was profitable.

Goal of grouping?

>500 hours or >100 hours?

101

(SPA recharacterization rule)

Reg. 1.1411-5(b)(2)(i) refers to 1.469-2T(f)(2)

Mordkin, T.C. Memo 1996-187
Re Board Member
Rev. Proc. 2010-13
Grouping Requirements

• Written statement attached to original return.

• The names, addresses, and EINs, if applicable, for the business activities or rental activities being grouped.

• A declaration that the grouped activities constitute an appropriate economic unit.
Trap

Don’t re-group and make LP’s XYZ income nonpassive if the taxpayer needs the passive income to free passive losses from another source.

Re-Proposed Regulations on Dispositions of Partnership Interests

Prop. Reg. 1.1411-7
IRC sec. 707(c) guaranteed payments for services are NOT NII (whether SE income or not)

Guaranteed payments for capital are like interest thus NII if not subject to SE tax
Per IRS LB&I website Q&As, partnerships with assets between $10 million and $50 million (or gross receipts over $35 mil.) will be allowed to file Schedule M-1 in place of the Schedule M-3, Parts II and III, effective for tax years ending on Dec. 31, 2014 and later.
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<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>1</td>
<td>Net income (loss) per books</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Guaranteed payments (other than health insurance)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a Depreciation $</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b Travel and entertainment $</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Add lines 1 through 4</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a Tax-exempt interest $</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a Depreciation $</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Add lines 6 and 7</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5</td>
<td></td>
</tr>
</tbody>
</table>

Part I still required
GAO Report--With Growing Number of Partnerships, IRS Needs To Improve Audit Efficiency (Sept. 18, 2014)
Commissioner Koskinen Statement on Oct 17:

"Our position is the most significant thing we can do to break that bottleneck...[is to] amend [the law] and say we can audit a partnership...."