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Participation of 100 Hours May Be Sufficient to Generate Active Income Exempt from the 3.8 Percent Health Care Tax on Net Investment Income

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As business owners begin filing their 2013 **federal income tax return**s and pay the 3.8 percent tax on **net investment income** for the first time, they should be aware that 100 hours of participation in an activity may be sufficient to generate active business income exempt from the 3.8 percent tax. As a result, taxpayers that have not met the oft-publicized 500-hour threshold of participation in an activity required to achieve active status would be wise to closely analyze whether their participation exceeds 100 hours.

The 3.8 percent tax on net investment income (the NII Tax) was enacted as part of the financing for the **Affordable Care Act**, and the tax became effective January 1, 2013. Tax advisers continue to gain more insight regarding its scope. We discuss the NII Tax regulations relevant to business owners whose income is not subject to self-employment tax. Business owners should be aware that income that is not subject to self-employment tax and is derived from activities in which the taxpayer participates more than 100 hours should be exempt from the NII Tax.

By way of background, the income a taxpayer derives from a business activity, if “active,” is exempt from the NII Tax, but if “passive,” is subject to the NII Tax. Income is generally active when the taxpayer “materially participates” in the business activity. We discuss certain situations in which a taxpayer’s participation in a business activity may not be material, but the income from such activity is nevertheless treated as active.

Whether business income is active or passive for purposes of the NII Tax is determined under the passive loss (PAL) rules enacted in 1986. Congress enacted those rules to prevent a taxpayer from taking tax losses against portfolio, salary and other non-passive income, unless the taxpayer was materially participating in the business or rental activity generating the loss. The Internal Revenue Service (IRS) regulations define material participation for individual taxpayers based on seven tests tied primarily to the annual hours the taxpayer works in the activity. The most frequently relied upon test provides that that a taxpayer materially participates in a business activity if the hours worked in such activity exceed 500 annually.

If the individual taxpayer spends more than 500 hours working in the business activity, the income from the business is active, and no NII Tax is payable on that income. Because each undertaking by a business is potentially a separate activity, business owners and their advisers have been analyzing whether all of an owner's various activities may be grouped together so that the owner can satisfy the 500-hour requirement by combining the hours worked in all of the grouped activities. Although a detailed discussion of the grouping of activities under the PAL rules is beyond the scope of this *On the Subject*, for example, a farmer might have separate activities of trucking, custom farming for other landowners and raising crops or livestock, or the farmer might be able to group all those undertakings and treat them as a single activity. If the grouping of activities could affect the NII Tax of a taxpayer, the taxpayer has the opportunity to regroup in 2013 or 2014. However, failing to regroup during those years may prevent future regrouping.

Notwithstanding the general 500-hour requirement for material participation, if a taxpayer spends more than 100 hours working in a business activity, the income from such activity may avoid the NII Tax. This is of greatest importance to a business owner who works 500 or fewer hours annually in a business activity because the income from any such activity nevertheless should be active and escape the NII Tax if the taxpayer works more than 100 hours. Regrouping, however, may still be necessary to create grouped activities in which the owner works more than the requisite 100 hours. Thus, this rule may not help an owner that works 100 or fewer hours in separate business activities, if those separate business activities may not be grouped under the PAL rules.

The conclusion that exceeding 100 hours of work in a particular activity is sufficient to avoid the NII Tax, rather than the oft-publicized 500 hours, results from the interplay between the NII Tax and the PAL rules. When the IRS issued the hours tests for purposes of determining material participation in the PAL regulations, the rules not only focused on sorting losses into an active or passive basket, but also on sorting income into those baskets. Because passive losses could be netted solely against passive income, the PAL rules limit the taxpayer's ability to generate passive income through the use of a passive income generator (PIG). The IRS' anti-PIG rules provide that certain business or rental activities produce non-passive income (which could not be offset by passive losses) and passive losses (which could not offset non-passive income).

When the NII Tax regulations were written, the IRS largely followed pre-existing income tax rules. Therefore, the IRS provided in its final regulations that income recharacterized as non-passive under the anti-PIG rules and *not* further recharacterized as portfolio income would be active income and escape the NII Tax. An example of income from a PIG that is non-passive but recharacterized as portfolio income, and therefore subject to the NII Tax, is "ground rents" (*e.g.*, cash-rented farmland). Another example of a PIG is a trade or business activity in which the owner works for more than 100 hours but not more than 500 hours, so that the owner does not materially participate. These PIGs are known as significant participation passive activities (SPPAs). If the taxpayer has more than one SPPA, the PAL rules essentially aggregate the income and loss from all SPPAs of the taxpayer and then treat the resulting net income as active or net loss as passive. What is important is that the net income in this case is *not* further recharacterized as portfolio income. For that reason, the income of an SPPA is not subject to the NII Tax, even though the owner does not materially participate.

On the other hand, a loss from an SPPA is passive, meaning that, to the extent that it offsets passive income, it can reduce the NII Tax. Because a passive loss can be deducted for ordinary income tax purposes only to the extent of passive income, a net passive loss from SPPAs will not further reduce net investment income subject to the NII Tax, unless the taxpayer has another source of passive income.

For example, assume a business has four activities that are SPPAs and that the owner of the business works approximately 120 hours in each of these activities. Further assume that the business has a fifth activity which generates significant income and which is not an SPPA because the owner only works approximately 50 hours a year in the activity. (Note that if the owner's hours in the four SPPA activities aggregated more than 500 hours, the owner would be treated as materially participating in each SPPA activity.) If the owner groups all five of these activities, the owner would have more than 500 hours and would be active in the grouped activity. Any active income would escape the NII Tax, and any active losses would be deductible for all tax purposes. However, if one further assumes that the owner also owns a rental activity that generates substantial passive losses, the losses from the rental activity could no longer offset the income from the fifth activity because all of the business income would be active. Instead, these rental losses would be suspended and reduce neither the ordinary income tax nor the NII Tax. Although the regrouping may save NII Tax, it would increase the ordinary income tax.

On the other hand, if the owner does not group all five activities, the fifth activity will generate passive income to net against the rental activity loss for ordinary income tax purposes. Although the income from the fifth activity would generally be subject to the NII Tax, the rental losses will reduce both the ordinary income tax and the NII Tax dollar for dollar, while any business income from the SPPAs will escape the NII Tax. Thus, although taxpayers should find relief in discovering that participation in excess of 100 hours should generally be sufficient to avoid the NII Tax, they should still carefully consider their SPPAs when planning to reduce the NII Tax.

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