**8567. What is the importance of whether trade or business activities are considered “passive” with respect to the taxpayer?**

Prior to the enactment of the net investment income tax, the relevance of “passive” activities was to limit deductible passive expenses to passive income.[[1]](#footnote-1) Now, as a result of the net investment income tax, the characterization of an activity as passive has new significance. As discussed in Q 8566, gross income derived from a trade or business and/or net gain attributable to the sale or exchange of property that is passive with respect to the taxpayer is included in net investment income subject to the 3.8% net investment income tax. To qualify for the exclusion, the taxpayer must “materially participate” in the business activity so as to make it a non-passive activity.

Section 1411 and the regulations reference the definition of passive activity set forth in IRC Section 469, indicating that the rules for determining whether an activity is active or passive apply in the context of determining whether the income is included in investment income.[[2]](#footnote-2) Whether an activity is passive or non-passive depends on the level of the taxpayer’s participation in the activity. A passive activity is any trade or business activity in which the taxpayer does not “materially participate.”[[3]](#footnote-3) Generally, a taxpayer is considered to *materially participate* in an activity if he is involved in the operations of the activity on a regular, continuous, and substantial basis. Many of the factors considered by the IRS involve the number of hours that the taxpayer devotes to the activity annually. The IRS may also compare the number of hours that a taxpayer devotes to the activity to the hours spent by others engaged in the same business. A traditional facts and circumstances test is typically applied in making a final determination. See Q 8606 for a discussion of the material participation requirement in the context of the passive activity rules.

So, if a taxpayer materially participates in a trade or business, it is considered non-passive; and, thus, the income described above would qualify for the exclusion. As an important caveat, even if the taxpayer participates in a trade or business, if the income from such business is considered to be self-employment income, it can never be considered net investment income. Instead, such income is subject to Medicare tax and potentially the Additional Medicare tax.[[4]](#footnote-4)

For a detailed discussion of the passive activity rules in general, see Q 8603 to Q 8612.

**8567.02 Can a taxpayer “group” multiple activities in order to meet the material participation test for purposes of the net income investment exclusion?**

Another way to meet the material participation test is to “group” several activities into a single activity to meet the material participation test. Under Treasury Regulation Section 1.469-4,[[5]](#footnote-5) one or more trade or business activities may be “grouped” and treated as one economic unit for purposes of determining whether the taxpayer materially participated. By doing so, the taxpayer’s participation for all the activities would be aggregated as if it was one activity. Whether or not the IRS will recognize grouped activities as a single economic unit is based on facts and circumstances. The following five factors are relevant in determining whether such activities qualify to be treated as a single economic unit:[[6]](#footnote-6)

(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.

Once a taxpayer has grouped activities, the taxpayer is generally not permitted to regroup those activities in later tax years.[[7]](#footnote-7) See Q 8567.03 for the limited exception to this rule.

**8567.03 Can a taxpayer regroup activities after an initial grouping has already taken place?**

Obviously, the grouping rules were the outgrowth of the passive activity income and loss rules that far predate the enactment of the net investment income tax. For the reason, allowing the taxpayer to regroup certain activities in view of net investment income tax considerations could potentially save a significant amount of tax.

The final regulations provide a small window allowing such a regrouping. In order to regroup,

1. the regrouping must occur only in the first taxable year beginning after December 31, 2012; and
2. the regrouping taxpayer must be subject to net investment income during that year.

In other words, regrouping is allowed only in the one single tax year referenced above, and, only if a taxpayer is subject to net investment income in that same year. Consequently, any taxpayer who is not subject to net investment income in that taxable year, but may be subject to it in a subsequent year, is not entitled to a “fresh start” regrouping.[[8]](#footnote-8)

**Planning Point**: In drafting the final regulations, the IRS refused to allow pass through entities such as S corporations and partnerships to regroup. In declining to do so, the final regulations noted that taxpayers not subject to the net investment income tax for the taxable year beginning after December 31, 2012, would get the benefit of regrouping indirectly (i.e., by virtue of the pass through of income from those entities), that they would not be entitled to receive directly.[[9]](#footnote-9)

For additional discussion of the passive activity rules in general, see Q 8603 to Q 8612.

1. IRC Sec. 469. [↑](#footnote-ref-1)
2. IRC Sec. 1411(c), Treas Reg. §1.1411-5(b). [↑](#footnote-ref-2)
3. .IRC Sec. 469(c). [↑](#footnote-ref-3)
4. IRC Section 1411(c)(6). [↑](#footnote-ref-4)
5. Treas. Reg. §1.469-4. [↑](#footnote-ref-5)
6. Treas. Regs. §§1.469-4(c)(1), 1.469-4(c)(2). [↑](#footnote-ref-6)
7. Treas. Reg. §1.469-4(e)(1). [↑](#footnote-ref-7)
8. Preamble to Final Regulations, 78 Fed. Reg. 72396. [↑](#footnote-ref-8)
9. Preamble to Final Regulations, 78 Fed. Reg. 72396. [↑](#footnote-ref-9)