

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XV - Being an Active Participant in the Trade or Business of an S Corporation Has Its Advantages

02.12.25

In this Part XV of my multi-part series on some of the not-so-obvious aspects of Subchapter S, I explore a potential advantage that the S corporation has over the C corporation.

The Patient Protection and Affordable Care Act, as modified by the Health Care and Education Reconciliation Act of 2010, effective January 1, 2013, imposes a three and eight-tenths percent (3.80%) Medicare tax (the "Net Investment Income Tax" or the "NIIT") under Code § 1411 on the lesser of:

- the taxpayer's "net investment income;" or
- the excess of modified adjusted gross income over a "threshold amount" (generally \$250,000 for taxpayers filing a joint return, \$125,000 for married taxpayers filing a separate return and \$200,000 in all other cases).

For this purpose, investment income generally means:

- gross income from interest, dividends, annuities, royalties and rents (other than such items that are derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or the trade or business of trading financial instruments or commodities);
- gross income from passive activities under Code § 469 with respect to the taxpayer or from the trade or business of trading financial instruments or commodities; and
- net gain from the disposition of property, other than property held in a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities.

To arrive at net investment income for purposes of Code § 1411, allowable deductions properly allocable to such income are deducted therefrom. T. Reg. § 1.1411-4(f).

Disposition of Shares

Some types of income are exempt from the tax, including income from the disposition of the shares of an S corporation, **provided** the shareholder is active in the trade or business carried on by the corporation. On the other hand, gain from the disposition of the shares of a C corporation regardless of whether the shareholder is active in the trade or business carried on by the corporation is subject to the NIIT.

Pass-Through Income of an S Corporation

An interesting provision contained in the legislation provides in general that income passing through to a shareholder of an S corporation who is an active participant in the trade or business conducted by the corporation is **not** subject to the NIIT. The NIIT, however, does apply to the pass-through income of a shareholder of an S corporation that is **not** active in the trade or business conducted by the corporation and the pass-through income of an S corporation derived from the trade or business of trading financial instruments or commodities.

By contrast, dividends received by shareholders of C corporations regardless of whether the shareholder is active in the trade or business carried on by the corporation are subject to the NIIT.

This law creates a slight tax advantage for the active shareholders of S corporations over shareholders of C corporations.

Material Participation/Active in the Trade or Business of the S Corporation

A precursor determination to applying the favorable treatment accorded to shareholders of S corporations is whether the shareholder is active or passive in the activities of the corporation. For this purpose, we look to Code § 469.

In accordance with T. Reg. § 1.469-5T(a), a shareholder will be considered an active participant in the activity of the S corporation if:

- the shareholder participated in the activity of the corporation for more than 500 hours during the year;
- the shareholder's participation in the activity of the corporation constituted substantially all the participation of all individuals in the activity;
- the shareholder participated for more than 100 hours in the activity of the corporation, and the shareholder's hours were not less than those of any other participant;
- the activity is a significant participation activity^[1] for the year, and the shareholder's aggregate participation in all significant participation activities exceeded 500 hours;
- the shareholder materially participated in the activity of the corporation for any five of the past 10 years;

- the activity is a personal services activity where the shareholder materially participated in the activity of the corporation for any of the three preceding tax years; **or**
- based on all the facts and circumstances, the shareholder participated in the activity of the corporation on a regular, continuous and substantial basis.

Conclusion

Hopefully the above discussion clearly illustrates that an S corporation may have an advantage over a C corporation relative to the NIIT. To qualify for the preferential treatment accorded to an S corporation shareholder with respect to gain from the disposition of shares and the pass-through income, however, the shareholder must be a material participant in the activity of the S corporation under the parameters set forth in Code § 469 and the corresponding Treasury Regulations.

Stay tuned for more blog posts in my multi-part series on some of the not-so-obvious aspects Subchapter S.

[1] See TAM 202229036 for a good discussion on what constitutes a significant participation activity.

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Authored by

[Larry J. Brant](#)

[Principal|Portland](#)

503.553.3114 larry.brant@foster.com