

Real Estate Professionals and the Net Investment Income Tax

Some of your clients will be subject to a nasty tax increase on their 2013 tax returns due to the 3.8 percent net investment income tax assessed under Internal Revenue Code section 1411. The IRS released final regulations ([T.D. 9644](#)) on December 2, 2013, which provide guidance on the general applicability of the net investment income tax (NIIT) and the computation of net investment income under section 1411. The regulations address a number of topics with respect to the NIIT, including estates and trusts, self-rented property, self-charged interest income, trader's gains and losses, and real estate professionals. This article focuses on the regulations' treatment of real estate professionals.

So who is covered and what types of income are subject to the tax? In general, the 3.8 percent tax applies to net investment income of certain individuals, estates, and trusts. Married couples filing joint returns are subject to the tax if they have net investment income and their modified adjusted gross income exceeds a threshold amount of \$250,000. For married individuals who have net investment income, but file separately, the threshold amount is \$125,000. Moreover, for a single person or head of household (with qualifying person), the threshold amount is \$125,000. The NIIT provides for special rules for exemption of nonresident aliens and dual-resident individuals from the scope of the tax.

Net investment income generally includes interest, dividends, capital gains, rental and royalty income, capital gains distributions from mutual funds, gain from the sale of investment real estate (including a second home), and gains from the sale of a "passive activity" interest in a partnership or S corporation.

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When proposed regulations on the NIIT were released in 2012, the IRS received numerous public comments suggesting that real estate professionals are engaged in a trade or business and materially participate in their rental real estate activities; and thus, such persons should *as the argument goes* be exempt from NIIT. Nevertheless, according to the final NIIT regulations released earlier this month, the Treasury Department and IRS did not entirely reject this argument – nor did they entirely buy into the argument either. The NIIT regulations state "...for several reasons, the Treasury Department and the IRS do not believe that every real estate professional is necessarily engaged in the trade or business of rental real estate."

The final regulations preamble emphasize that *the analysis* -- regarding whether a person qualifies as a real estate professional under the passive activity rules of Internal Revenue Code section 469 -- is not the same as determining who is a real estate professional operating a trade or business under the NIIT rules of section 1411. In fact, the IRS has determined that the definition of a trade or business under the NIIT and section 1411 *is* broader than the trade or business definition for purposes of the passive activity rules.

In acknowledging that the determination as to who is a real estate professional for purposes of the NIIT is complex, the NIIT final regulations create a "safe harbor test" for certain real estate

professionals under Reg. section 1.1411-4(g)(7). Under this section, if a real estate professional participates in rental real estate activities for more than 500 hours per year in five of the last ten taxable years, then the rental income associated with that activity will generally be considered to be derived in the ordinary course of a trade or business; and thus, exempt from taxation under the NIIT rules of section 1411. However, if the taxpayer does not satisfy the safe harbor test of regulation section 1.1411-4(g)(7), the taxpayer will not be precluded from establishing that he is not subject to the NIIT under some other method.

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