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Real property rental income and the new 3.8% unearned income medicare tax

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Beginning in 2013, taxpayers with modified adjusted gross income (MAGI) over $200,000 ($250,000 for a joint return or $125,000 for married filing separate) will be subject to a 3.8% surtax (MCT) on net investment income. Net investment income includes, income from rents, interest, dividends, annuities and royalties -- unless this income is derived in the ordinary course of a trade or business.

Like most tax legislation, the concept seems simple. Subject high income taxpayers to a Medicare type tax on their net investment income that is not derived from an active trade or business. However, as with all tax legislation, the execution is in the details. Although Treasury has released proposed regulations in 2012 that provide some guidance for calculating the MCT, there are still open questions and issues that will need to be resolved in the future -- especially since Treasury has adopted an active trade or business standard for real estate investors. A taxpayer calculates his/her taxable net investment income subject to the MCT in two steps:

Step 1- Add the sum of (i) gross income from rents, interest, dividends, annuities and royalties not derived in the ordinary course of an active trade or business, (ii) gross income from a trade or business that is considered a passive activity (one in which the taxpayer does not materially participate) and (iii) net gain from the disposition of property not held in an active trade or business that is includable in his taxable income.

Step 2- Subtract deductions that are allocable to the gross income or net gain included in the above income, including rental deductions.

There are at least three fact patterns that real estate investors may face when determining whether their net rental is subject to the MCT:

1- Non real estate professional owners of residential or commercial buildings -- that is, a taxpayer that owns a commercial or residential rental, will be subject to the MCT on their net rental income under the general rule noted in Step 1(i) above.

2- Passive Owners of LLC or LP interests that invest in real estate will most likely be subject to the MCT under either the general rule of Step 1(i) or as a passive member in an active trade or business under Step 1(ii).

3- A Real Estate Professional (REP) needs to analyze his situation in more depth to determine if his net rental income will be subject to the MCT. It is likely that the taxpayer will not be subject to the MCT if he: (a) qualifies as a REP under IRC 469, (b) materially participates in the real estate activities, (c) properly groups his activities under 469 and (d) can show that his real estate activities rise to the level of an active trade or business.

As the preamble and regulations provide, qualifying as a REP does not automatically mean that he is conducting a trade or business. A REP needs to analyze his real estate activities under IRC Code section 162 concepts to determine whether, based on all facts and circumstances, his activities rise to the level of a trade or business rather than an investment activity. This analysis may prove problematic.

Although Treasury's proposed regulations and preamble are helpful in analyzing the applicability of the MCT to some real estate investors, additional guidance is needed, especially for real estate professionals, to properly determine whether their activities rise to the level of an active trade or business.

Thomas Astore, CPA JD, is a partner with Rodman & Rodman, P.C., Newton, Mass. and is a monthly contributing Certified Public Accountant author for the New England Real Estate Journal's Green Building section.