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New medicare tax on investment income urges a closer look at "Real Estate Pro" election

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Real estate professionals may want to pay closer attention to the way they do business. That's because the number of hours they spend in the real estate businessâ€”and the amount of time actually spent managing rental propertiesâ€”will have a big impact on whether or not they pay the new 3.8% Medicare tax on investment income.

For example, a real estate professional with $1 million of rental income, could save more than $30,000 in taxes annually by qualifying as a "real estate professional." For those with larger real estate holdings, the annual tax savings could be exponentially significant.

Who Saves?

The 3.8% tax, enacted as part of health care reform, is designed to raise an estimated $210 billion to fund Medicare by taxing investment income. Previously, investment income such as capital gains, dividends, taxable interest and rental activities was exempt. The new tax applies to those taxpayers meeting certain income thresholds, $250,000 for married couples filing jointly and $200,000 for single taxpayers.

The accompanying chart illustrates the significant tax savings for real estate professionals. A married taxpayer with wages of $120,000, net investment income (from sources such as interest and dividends) of $200,000, and $1million of rental income would save $33,060 if he/she qualifies as a real estate professional compared to someone who does not meet that qualification.

Who Qualifies?

The real estate professional designation has been around since the 1980s, but it has been primarily used so that professionals could use losses from their real estate operations to offset other income. Those with profitable operations may have never considered making the election to become a real estate professional.

The new Medicare tax makes this election much more attractive, since it turns otherwise passive income into non-passive income, which is exempt from the 3.8% tax.

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