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The Real estate professional and 3.8% tax on net investment income - Part 1

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Many of our clients own and/or operate rental real estate. Prior to 2013, for some such clients, there was no real advantage in electing to aggregate real estate activities to avail oneself of the "Real Estate Professional" status under the Section 469 passive activity rules. However, beginning in 2013, new Section 1411 will subject "net investment income" (for taxpayers with income above certain thresholds) to a 3.8% Medicare tax and real estate professional status can be the key to avoiding the new tax. "Net investment income" is defined to include interest, dividends, annuities, royalties, and rents (other than income derived from an "active trade or business") as well as, net gain attributable to the disposition of property, other than property from an "active trade or business", less allocable deductions. Net rental income, as well as gain from the disposition of the rental activity, will be subject to the 3.8% tax unless the income is considered "non-passive" and "derived in the ordinary course of a trade or business."

The Real Estate Professional:

So how does one get the income from their rental activities, including gain from the sale of rental properties to be characterized as "non-passive?" Such income is assumed to be "per se passive" by definition under Section 469. However, Code Section 469 provides an exception to the "per se passive" rule for a taxpayer that qualifies as a "Real Estate Professional."

A taxpayer qualifies as a "Real Estate Professional" if he, or she, spends more than half of their time performing personal services in "real estate trades or businesses" in which they "materially participate", and, such time is more than 750 hours.

Many of our clients have trouble meeting the "material participation" standard without what is referred to as an "aggregation election". In the real estate context, whether a taxpayer materially participates in a rental real estate activity, generally, is determined as if each of the taxpayer's interests in real estate is a separate activity. Section 469(c)(7)(A)(ii), however, permits a real estate professional to aggregate all interests in rental real estate into one activity. Absent such an election, the taxpayer would be required to separately participate for more than 500 hours (or meet one of the other "material participation" tests) in each rental real estate activity which the taxpayer intends to qualify as "active," or "non-passive." Therefore, the election is helpful in situations where the taxpayer has insufficient participation in each separate rental real estate activity, but can establish "material participation" if their interests with respect to all rental real estate activities are combined.

Part 2 of this article will discuss the impact of new tax Code Section 1411 on Real Estate Professionals.

Part 2 will appear in the October 11th edition of NEREJ in the Financial Digest section.

Dennis Pellicchia, CPA and chairman, president and CEO of Braver PC, Needham Mass. - John Britto, CPA and manager at Braver PC contributed to this article.

