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## Net investment income tax includes real estate: Do you qualify for one of the exceptions?

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As businesses and investors file their tax returns they are starting to feel the full impact of the tax increases that began in 2013. One of the most talked about changes is the Net Investment Income Tax (NIIT) which imposes a 3.8% additional tax on high earners. As the name implies, the tax applies to net investment income, which includes interest, dividends, and capital gains. However, the tax also applies to passive income as well. Does this put rent and some business income in the cross-hairs of the tax? Like all tax questions the answer is: It depends.

Code Section 1411(c)(1)(A) specifically includes both rents and net gains attributable to the disposition of property, making the default treatment an inclusion in NIIT. Thus, taxpayers must find an exception in order to omit such income from the tax. The first exception is income derived in the ordinary course of a trade or business, if such trade or business is a passive activity with respect to the taxpayer. There are two hurdles in this statement: what is a "trade or business" and "what is a passive activity?"

Neither  $\text{Å}\text{§}1411$  nor the regulations define trade or business. However, the preamble to the regulations point to Code Section 162 and case law for determining its existence. Most importantly, the Supreme Court held there are two requirements for a trade or business: 1) the activity must be conducted for income or profit; and 2) the activity must be engaged in with some regularity and continuity (Groetzinger, 59 AFTR 2d 87-532, 480 US 23, 107 S Ct 980, 94 L Ed 2d 25(1987)). The examples in the regulations are lacking in specificity on the topic when rent is involved, merely stating an individual "is not involved in the activity of the commercial building on a regular and continuous basis, therefore, [the] rental activity does not involve the conduct of a trade or business."

In addition to the trade or business question is the determination of a passive activity, the second prong of the test. Code section 469 has well established rules covering a passive activity. The primary indicator is the numbers of hours spent on the activity and amount of service given. A rental activity is by default a passive activity ( $\text{Å}\text{§}469(c)(2)$ ). Since the default for rents is passive, the NIIT will apply unless an exception applies but, yet again, they do exist.  $\text{Å}\text{§}469(c)$  introduces the concept of "material participation" to carve out an exception to passive activities. There are seven safe-harbors for material participation, they are: 1) participating more than 500 hours; 2) substantially all participation in the activities time regardless of hours; 3) participation in the activity more than 100 hours & more than anyone else's participation; 4) the activity is a "significant participation activity" and all such activities hours are more than 500; 5) an individual materially participating in the activity for 5 out of the last 10 years; 6) a personal service activity; and 7) materially participating based on facts and circumstances. Real estate professionals may find their own relief from the NIIT. A real estate professional is an individual who performs more than half of their personal services in real property trades or businesses and performs more than 750 hours of

services during the tax year (in real property trades or business in which the taxpayer participates). This includes such activities as construction, development, rental, brokerage, and management to name a few. Taxpayer may also make an election (annually) to group activities in order to meet the hour requirement to be considered a real estate professional. The benefit is that real estate professionals are, by rule, not subject to the NIIT.

Although rent is otherwise a passive activity, there is yet another rule which can change the character into non-passive income regardless of participation level. It is self-renting. Originally written as a punishment for attempting to convert non-passive income into passive income, the rules give relief from the NIIT. The self-rental rules state that related party rentals will change the nature of the rent from passive to non-passive if the net activity results in profit. A quick example highlights the concept: A taxpayer owns and participates in a manufacturing company that pays rent to the taxpayer's LLC. The net rental income (assuming a profit) is re-characterized from passive to non-passive because the two entities are related. In the present case they are related because of common, 100% ownership.

One can see that there is a two tier test, but who makes these determinations when property is owned in a partnership or limited liability company? The existence of a trade or business is determined on the entity that generates the income, i.e. partnership level; however the active/passive determination is made at the partner/individual level (Reg. 1.1411-4(b)(2)).

In conclusion the net investment income tax is complex with regard to real estate activities. Taxpayers should take a closer look at their activities and their involvement in them in order to determine if they qualify for one the exceptions to the tax. Considerations must be given regarding trade or business activities, passive activities, material participation, real estate professional status or self-rental.

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