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New safe harbor rule exempts real estate professionals from Medicare tax

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In 2013, a new 3.8% Medicare tax was implemented on investment income which includes investments in real estate. This tax could be significant for many taxpayers, but there's good news for real estate professionals.

A safe harbor rule has recently been issued that allows real estate professionals to classify income from real estate investments as trade or business income rather than investment income. If the taxpayer qualifies under the safe harbor rule, their rental income is not subject to this tax.

It's not too late to take advantage of the safe harbor rule for taxpayers that qualified in 2013. To take advantage, a taxpayer must qualify as a "real estate professional" and must also meet one of two tests based on the number of hours spent in the real estate business. A taxpayer that qualifies as a real estate professional and meets the hours required could save more than $30,000 in taxes on $1 million of rental income. For individuals with larger real estate holdings, the annual savings could be exponentially significant.

Real Estate Professionals

The designation of a real estate professional has been around since the 1980s and was primarily elected so that professionals could use losses from their real estate operations to offset other income. Now with the implementation of the new Medicare tax, the designation has become even more important for people in the real estate industry.

The requirements for being classified as a real estate professional are stringent, which makes it impossible to qualify unless real estate is your primary business. To qualify, more than 50% of a taxpayer's personal services must be spent in real property trades or business. The taxpayer must also perform at least 750 hours of services in real property trades or business in which he or she materially participates. Once the taxpayer qualifies as a real estate professional, they must also meet one of seven material participation tests each year. The material participation test excludes hours spent on management, leasing, and brokerage.

The Safe Harbor Rule

Under the safe harbor rule, if the real estate professional meets either of the following material participation tests, their rental income is automatically excluded from the Medicare tax:

* Participating in rental real estate activities for at least 500 hours in the tax year
* Participating in rental real estate activities for at least 500 hours in any five of the last ten tax years

If they establish material participation under one of the other five rules, the taxpayer is not precluded from treating their income as trade or business and thus not subject to the Medicare tax, but it will depend on the facts and circumstances of the taxpayer. The IRS could potentially challenge a real estate professional designation that is met under the other five material participation tests.

Taxpayers don't have to make the election to be a real estate professional until it's time to file their tax return. This gives them time to evaluate the potential impact of the Medicare tax and make a decision on whether or not the designation is the best course of action.

Getting classified as a real estate professional can be complicated and the designation is permanent. It's important to have an advisor who can walk you through the process.

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