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CAUGHT IN THE 'NIIT'

Understanding And Avoiding The Medicare Surtax Real Estate Pitfalls

Surtax Puts Additional Emphasis On Tracking Work Hours

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SPECIAL TO BANKER & TRADESMAN

The IRS offers little help, in the way of concrete, practical examples, of what is, and isn't in the "ordinary course of a trade or business."

Real estate professionals whose time-keeping is lax or who do not materially participate in the business could be blindsided by the new 3.8 percent Medicare surtax, which could add thousands of dollars to their tax bill this year.

The 3.8 percent Medicare surtax, also known as the Net Investment Income Tax (NIIT), was enacted in 2010 to help fund the Affordable Care Act, and took effect Jan. 1, 2013. The surtax puts additional emphasis on real estate professionals to track their work hours and to reevaluate their investment strategies to avoid the surtax's sting.

What Is NIIT?

The NIIT is a tax on net investment income and is applicable to the single taxpayer who has modified adjusted gross income over $200,000, or over $250,000 for those who are married and filing jointly.

Net investment income includes interest, dividends, capital gains, rental and royalty income, and income from businesses that are passive activities to the taxpayer, as defined by the Tax Code. Gains from the sale of real estate investments, including the sale of a second home that is not the primary residence, count as net investment income.

Real Estate Professionals

Although rental income is generally classified as passive income and subject to the surtax, an exception is made for "real estate professionals." For purposes of the surtax, "real estate professionals" are given the opportunity to demonstrate that they "materially participate" in their rental activities.

Real estate professionals who generate rental income through active participation in renting properties are engaged in non-passive rental activities, which, traditionally, should spare them from getting socked by the NIIT.

The IRS views real estate professionals as individuals who:

- Materially participate in a trade or business in which they hold at least a 5 percent ownership interest;
- spend more than half of their professional time during the tax year performing services for real property trades or businesses; and
- spend more than 750 hours during the tax year performing services for real property trades or businesses.

Material participation means active involvement in daily management of real estate, such as meeting with contractors, and devoting more than 500 hours of one's time. Real property trades or businesses include activities such as development, construction, acquisition, conversion, renting, operating, managing or brokering real property.

Regarding the 750-hour target, real estate professionals might consider tracking their hours through Microsoft's Outlook calendar or a similar tool that may be submitted as verification to the IRS.

One way to reach the 750-hour threshold is to employ a Tax Code election that enables a qualified taxpayer to treat multiple rental real estate interests as a single real estate activity if the grouping constitutes an appropriate economic unit, a determination made by examining facts, such as common control or geographic location. Taxpayers make this election by filing a statement along with their tax return. For example, a taxpayer who owns five pieces of real estate to which he or she devotes 150 hours each may satisfy the requisite 750 hours and avoid NIIT by electing to group his or her efforts on the five properties as a single real estate activity.

Real estate professionals also enjoy a safe harbor from NIIT if they have participated in at least 500 hours of real estate rental activities during the current tax year, or if they participated in more than 500 hours in any five taxable years during the 10 taxable years immediately preceding.

Under NIIT, real estate professionals have the onerous burden of having to prove they derived their rental real estate income during the ordinary course of a trade or business, as defined by the Tax Code. The IRS offers little help, in the way of concrete, practical examples, of what is, and isn't in the "ordinary course of a trade or business."

The new surtax may encourage taxpayers to consider jettisoning some properties at a loss to minimize their potential NIIT liability. Additionally, part-time real estate professionals should increase their activities to reach the 750-hour threshold to avoid what could be a significant tax burden. ■

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