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BUSINESS TRANSACTIONS & TAX PRACTICE GROUP | JULY 2016

Otten Johnson Alert -

Net Investment Income Tax Under the Affordable Care Act: Implications for Real Estate Professionals with Rental Income

Six years have passed since Congress enacted the Affordable Care Act, and taxpayers are still wondering how they can minimize their liability under the Act's net investment income tax ("NIIT"), which went into effect in 2013.

NIIT is a 3.8% Medicare surtax applied to the lesser of a taxpayer's net investment income or modified adjusted gross income once a taxpayer earns above statutory thresholds. Because NIIT only applies to the lesser of the two categories—net investment income or modified adjusted gross income—taxpayers can minimize or altogether eliminate their NIIT liability by minimizing income in either category. This Alert focuses on one strategy available to real estate investors to minimize their net investment income for NIIT purposes.

The Internal Revenue Code's definition of "net investment income" includes rental income. However, it excludes rental income that is derived "actively" in "the ordinary course of business." In practical terms, income derived from the rental of real estate is per se passive, and thus taxable as net investment income for NIIT unless the taxpayer qualifies as a "Real Estate Professional" under the Internal Revenue Code. To qualify as a Real Estate Professional, a taxpayer must: first, spend half of his or her time engaged in "real property trades or businesses" including development, construction, acquisition, conversion, property management, leasing, or brokerage; and second, that time must add up to at least 750 hours.

Once a taxpayer qualifies as Real Estate Professional, the taxpayer must still prove that his or her participation in the rental activities (and only the rental activities) was "material." For Real Estate Professionals that have rental income from many sources, the material participation test can be difficult to meet because under the default rule, the Real Estate Professional must satisfy the test relative to each rental property. Enter what tax professionals call a "-9 Grouping Election." Under a -9 Election, Real Estate Professionals who do not satisfy the material participation test for each rental property can elect to consolidate rental property activities, which has the effect of satisfying the test for every property in the group.

The Affordable Care Act offers a new incentive to convert passive income, which is subject to NIIT, to active income, not subject to the tax. If a taxpayer qualifies as a Real Estate Professional, he or she can use the -9 Election to more easily satisfy the material participation test, thus converting passive income to active, and in doing so, removing the rental income from potentially being subject to NIIT.

2016 summer clerk, Alex Gano, contributed to this alert.

Otten Johnson's attorneys have substantial experience with helping clients navigate business issues like those highlighted in this alert. For more information, or for help evaluating your current situation, contact any of the attorneys in the Business Transactions & Tax practice group.

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Colorado Real Estate Blog—Otten Johnson hosts a blog about development, financing and other property news in Colorado. Our attorneys are posting information and commentary on legal issues and business developments related to the real estate industry in Colorado and the West. Check it out: rockymountainrealestatelaw.com.

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