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Real Estate

Examination of Business Activity Grouping Key for 2014 Net Investment Tax Planning

BNA Snapshot

Impact of Final Section 1411 Rules on Real Estate Industry

Key Finding: The one-time regrouping of activities for certain taxpayers subject to NII requires consideration of current business activity groupings.

Key Takeaway: Careful record keeping is required for real estate taxpayers seeking to meet certain tests of material participation in an active trade or business.

*By **Lydia Beyoud***

Examination of current business activity grouping will be the most fertile area for 2014 net investment income tax planning for real estate professionals and other taxpayers, tax professionals told Bloomberg BNA.

"That's something that needs to be done now" for taxpayers who may be subject to the tax, Michael J. Greenwald, principal and Business Entity Tax Practice leader at Friedman LLP in New York, said Dec. 2.

The Internal Revenue Service issued final regulations Nov. 25 on the 3.8 percent surtax under tax code Section 1411. The net investment income (NII) tax became effective Jan. 1, 2013, on net unearned income or investments above a certain threshold related to certain individuals, estates and trusts.

For married taxpayers filing a joint return, the amount is $250,000; for individual returns, the amount is $200,000. Married taxpayers filing separate returns are subject to tax on income above $125,000.

The final rules include some very taxpayer-favorable changes for real estate professionals, and also made a concerted effort to incorporate many of the comments submitted on the complex regulations, several practitioners have told Bloomberg BNA since the rules' release.

Regrouping of activities was a major point of concern for many practitioners.

Regrouping of Activities

The final rules retained a provision from the proposed rules that allows for a one-time regrouping of activities in the first year they are subject to the tax. However, passthrough entities, including partnerships and S corporations, aren't permitted to regroup at the entity level.

The preamble to the rules also addressed practitioner concerns on the potential unfairness to certain

taxpayers whose regroupings could be affected if, upon examination or after adjustments to an original return, a taxpayer is determined to be-or not to be-subject to the surtax. "That's a question a lot of us had," Greenwald said.

The final regulations allow a taxpayer to regroup under Treasury Regulations Section 1.469-11(b)(3)(iv) on an amended return provided he or she wasn't subject to Section 1411 on his or her original or previously amended return, and if the taxpayer owed tax under Section 1411 for that taxable year because of the change to the original return.

Regrouping on an original return will be void, with certain exceptions, if a taxpayer is later found to not be subject to NII tax in that year and all subsequent years until a valid regrouping is done, the IRS said.

Taxpayers will now need to examine the interplay between Section 469 rules-which address passive activities and real estate professionals-with those of Section 1411 to determine what makes the most sense for their clients' activities, Greenwald said.

Passthrough Entities

The final rules didn't allow a regrouping election for passthrough entities out of concern that such an expansion of the regulations would allow partners and shareholders in S corporations with no net investment income tax liability to still obtain the benefit of regrouping.

"We need to keep in mind that the partnership and S corporation cannot regroup, but all that means-in perspective-is that the individual partner or shareholder has to accept whatever grouping the partnership or S corporation reports," said Michael J. Grace, counsel at Whiteford, Taylor & Preston LLP in Washington, told Bloomberg BNA Nov. 27.

If a partnership decides to combine 10 activities into one and report it as a single activity on its return, partners won't be able to pull those activities apart and put them into new groupings, he said. "But they can then take that activity and further group it with activities owned outside the partnership," Grace said.

The drafters' refusal to allow the entity to do a one-time regrouping isn't necessarily a "fatal result" for partners and shareholders themselves, Grace said.

The impact of the regrouping provisions means that "we're going to have to take a hard look at how we've been aggregating activities within entities, how they're organized in general," Greenwald said.

"You don't want to change the way you do business just based upon the taxes," but some reorganization may be likely for certain taxpayers, Greenwald said. Practitioners will have to look at it "in the totality of the tax planning, not merely with regard to the net investment income tax," he said.

Income Recharacterization

The treatment of nonpassive rental activities in the final rules is a very favorable change from their proposed form, said Grace. "It basically aligns Section 1411 with the results from the same transaction under 469," he said.

The final rules allow rental income, which is generally treated as passive income under Section 469, to be recharacterized as nonpassive by reason of Treas. Regs. Section 1.469-2(f)(6) for taxpayers in a self-rental situation, such as when a taxpayer rents property he or she owns to an activity in which he or she materially participates.

Under the proposed rules, "the question was whether that same result would occur under 1411," said Grace, who was the primary drafter of Section 469 in his former role at the IRS.

The government sought to prevent passive income under Section 469; under Section 1411, "the government has the completely opposite agenda," he said. The drafters of the NII tax may have decided to align the two rules for the sake of simplification as well as for economic reasons, Grace said.

"I think they concluded that by making this favorable change, they weren't going to be giving away too much," he said.

An equal consideration may have been that ultimately, a self-rental situation in which a taxpayer materially participates is essentially one business, even though there is a rental arrangement between a taxpayer's business and property, he said.

"If you do that, it becomes one trade or business depending on grouping, so it would make everything nonpassive," Grace said.

Safe Harbor

One of the most welcome provisions in the final rules for many taxpayers is the safe harbor for real estate professionals, multiple practitioners said.

"Not all real estate professionals are created equal" under different code sections, Kenneth Weissenberg, a partner with EisnerAmper LLP in New York, told Bloomberg BNA Dec. 2.

The final rules seek to protect the notion that rents not derived in the ordinary course of a trade or business are per se passive under Section 1411, said Grace. "They're making the point that just because you're a real estate professional, that doesn't necessarily mean that the rental side of your business rises to the level of a trade or business," Grace said.

To escape the NII surtax, a real estate professional must satisfy certain tests that their activities qualify as an active trade or business. A real estate broker that owns a handful of small properties that they lease to individuals as residences may likely not be able to characterize the income from that activity as non-investment income, Weissenberg said.

However, the IRS did offer a safe harbor for taxpayers involved in rental real estate: Individuals who spend at least 500 hours materially participating in their rental real estate activities, or taxpayers who spent more than 500 hours involved in their rental real estate for any five out of the last 10 years will be considered a real estate professional for the purposes of the NII tax, Weissenberg said.

Another boon for real estate professionals in the final rules is the ability to aggregate rental activities for the purposes of meeting the 500 hours test, Greenwald said.

Real estate developers, managers and those involved in the ongoing process of developing real estate may be the taxpayers who stand to benefit under these provisions of the final Section 1411 rules, Grace said.

Added Value

Taxpayers who fail the 500-hour safe harbor test may still not automatically be subject to the 3.8 percent tax. One way to determine if a taxpayer can satisfy the real estate professional test is to examine whether their services add value to a rental property, Weissenberg said.

"If you have one building that you spend a lot of time renting-but not 500 hours-and that's all you have, that could still be considered a trade or business," he said.

If rental activities amount to more than just routine maintenance and collecting rent, but actually improve the worth of a property and require day-to-day decision making, "it is arguably a trade or business as opposed to an investment," Weissenberg said.

Gray areas in making this determination will persist, he said. Even if a taxpayer significantly adds to the value of a single property, the activities may not rise to the level of a trade or business, he said. "If they do it with two or three, it's clear they're running a business, even if not coming in at 500 hours of total time," he said.

In a broader reaction to the final rules, Grace said it was helpful that the drafters affirmatively stated that they would rely on Section 162, in addition to decades of case law, to help identify whether an activity is a trade or business.

The proposed rules had merely made the observation of the intersection of the two code sections in the preamble, Grace said. Indeed, the intersection of so many other tax codes with Section 1411 is one of the elements that led to the rules' complexity, he said.

The government's confirmation that it had tried to incorporate the items addressed in the preamble into the final regulations is "a positive change because preambles disappear over time," Grace said.

Material Participation of Trusts

Multiple practitioners said that the decision by the IRS and Treasury Department to delay guidance on the material participation of estates and trusts is understandable given the complexity of drafting the larger package of Section 1411 rules, but will also leave many taxpayers waiting for greater clarification.

The material participation of trusts and estates issue arises frequently as real estate tends to be held within families, Steven R. Schneider, a partner with Goulston & Storrs PC in Washington, said Nov. 29.

Second or third generations of families are frequently active in their family trusts and qualify as real estate professionals and thus escape the NII tax, Schneider said.

"The question is how does that professional work with the trust" when they are receiving income or serving as a trustee, he said. "We really need some clarification," said Schneider.

The IRS indicated in the final rules that it may issue a separate guidance project on the issue under Section 469 at a later date. For now, the agency is accepting comments, "including recommendations on the scope of any such guidance and on specific approaches to the issue," the rules said.

Contemporaneous Documentation

Accurate and contemporaneous record-keeping will be vital for taxpayers who wish to substantiate that their real estate activities should qualify as an active trade or business and that they meet the real estate professional tests, practitioners said.

"Keeping a record of your involvement with respect to the properties and with respect to the real estate professional activities is very important," Weissenberg said.

"The burden is on the taxpayer to establish the amount of time they spend with respect to these properties," he said.

"Our recommendation to clients will be even stronger to maintain logs. If you want to qualify your income as being from a trade or business, it's always good advice," Greenwald said.

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