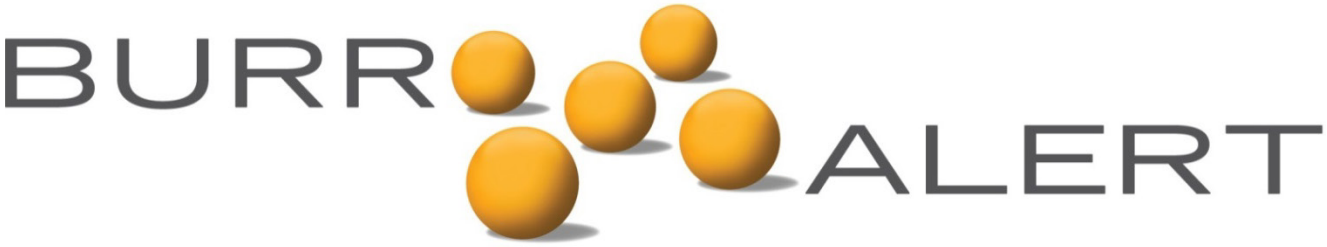

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IRS Changes Course and Provides Safe Harbor for "Real Estate Professionals" in Net Investment Tax Final Regulations

Section 1411 of the Patient Protection and Affordable Care Act (the "ACA") levies a new 3.8% tax on "net investment income" (the "NII Tax"). Among other things, the net investment income subject to the NII Tax includes certain "gross income from interest, dividends, annuities, royalties, and rents" not earned in the ordinary course of a non-passive trade or business. As a result of this new tax, many landowners who receive rental income from real property (and who also exceed certain modified adjusted gross income thresholds) may soon experience an increased tax liability on account of their rental real estate activities.

Fortunately, the Internal Revenue Service ("IRS") in its recently released final regulations provided a safe harbor from the NII Tax for qualifying "real estate professionals." This safe harbor came as somewhat of a surprise, however, because the proposed regulations previously published by the IRS suggested that it would be more difficult for real estate professionals to avoid application of the NII Tax. Under the regulations as initially proposed, a taxpayer could avoid the NII Tax due to his or her status as a real estate professional only if the taxpayer: (i) qualified as a real estate professional under I.R.C. § 469(c)(7)(B), (ii) materially participated in the rental activity, and (iii) earned the rental income in the ordinary course of a trade or business. After some grumbling from commentators following release of the proposed regulations, the IRS changed course and provided the 500-hour safe harbor described below.

The good news that emerges from the final regulations—for real estate professionals, at least—is that certain real estate professionals are no longer required to satisfy the "ordinary course of a trade or business" prong of the test outlined above. In fact, under the final regulations, "if a real estate professional . . . participates in rental real estate activities for more than 500 hours per year [or for more than 500 hours per year in five of the last ten taxable years], the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business." This is good news because, under existing tax laws, the determination whether an activity rises to the level of a trade or business normally involves the interpretation and application of decades of opinions from both the IRS and the courts. The safe harbor eliminates the need for a facts-and-circumstances inquiry and establishes at least some certainty in the application of this new and otherwise uncertain tax.

Under the final regulations, a taxpayer may now take advantage of the safe harbor found at Treas. Reg. § 1.1411-4(g)(7) and avoid the NII Tax by establishing two things: (i) that the taxpayer is a "real estate professional" under I.R.C. § 469(c)(7)(B) ("Section 469") and (ii) that the taxpayer participates in rental real estate activities (as defined in Treas. Reg. § 1.469-1T(e)(3)) for more than 500 hours per year (or for more than 500 hours per year in five of the last ten taxable years). Ignoring for a moment

a few complex aggregation rules, the 500-hour requirement is, for our purposes here, straightforward enough to be set aside. The rules in Section 469 defining what constitutes a real estate professional will, however, require a little more discussion.

Under Section 469, a taxpayer qualifies as a "real estate professional" if the taxpayer (i) performs more than one-half of the personal services he or she performs in a taxable year in *real property trades or businesses* in which he or she materially participates and (ii) performs more than 750 hours of services during the taxable year in *real property trades or businesses* in which he or she materially participates. Section 469 further defines "real property trade or business" to include any trade or business involving "real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage." Taken together, this language likely permits a taxpayer receiving rental income to group other non-rental real estate activities when attempting to qualify as a real estate professional under Section 469.

When determining whether a particular taxpayer can take advantage of the safe harbor, many challenging questions emerge, and the brief overview provided above is only the tip of the iceberg. Taxpayers considering the safe harbor should consult with their tax advisors about the particular circumstances of their rental real estate activities, including, among other things, taxpayer status when multiple pass-through entities are involved (as is often the case when real estate is involved), the classification and grouping of rental and non-rental real estate activities as real property trades or businesses, the materiality of their participation in real estate activities, the impact of the safe harbor on capital gains versus ordinary income characterizations, and the aggregation of time spent managing multiple properties for purposes of the 500-hour requirement under the safe harbor rules. Most importantly, taxpayers should work closely with their advisors to ensure consistent tax treatment of real estate activities across their portfolio.

Finally, one last note is worthy of mention. The final regulations specifically provide that the safe harbor is not the exclusive means by which a real estate professional can avoid application of the NII Tax. In other words, a taxpayer can avoid imposition of the NII Tax if he or she can establish that the rental income is derived in the ordinary course of a trade or business and that the rental activity is not a passive activity under existing tax principles.

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