

The New 3.8% Medicare Surtax and Real Estate Professionals

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2013 was a significant year for many taxpayers. Not only did the income tax rates increase, but the 3.8% Unearned Income Medicare Contribution Surtax came into effect. Prior to 2013, only earned income was subject to this tax. With the new 3.8% tax, a greater group of taxpayers will be affected.

As part of the 2010 Patient Protection and Affordable Care Act, Congress passed the new 3.8% tax. This tax is outlined in the Internal Revenue Code Section 1411. The Final Regulations Section 1.1411 were recently issued, providing guidance, clarification, and recommendations to some uncertainties that arose with the proposed regulations.

Understanding the 3.8% Tax

To understand the application of this new tax, a general knowledge of these terms is important:

- Net Investment Income
- Modified Adjusted Gross Income
- Threshold Amount

Net investment income includes interest, dividends, net gain from disposition of property (other than property held in a trade or business), annuity, rents, royalties, and trade or business income from a passive activity. Certain income items are excluded, such as wages, bonuses, distributions from IRAs or qualified retirement plans, self-employment income, gain on sale of an active interest, and tax-exempt income (municipal bond interest).

The Modified Adjusted Gross Income is the taxpayer's Adjusted Gross Income (AGI) plus net foreign earned income exclusion and certain items of foreign income from controlled foreign corporations and passive foreign investment companies. This amount is compared to the threshold amount to determine if the net investment income is subject to the surtax.

If the net investment income or modified adjusted gross income exceeds the threshold amount, then the surtax will apply. The threshold amounts are:

Single	\$200,000
Married taxpayers	\$250,000
Married filing separate	\$125,000

Application of 3.8% Tax

The 3.8% tax is applied to the lesser of (1) net investment income, or (2) the excess amount (if any) of Modified Adjusted Gross Income and threshold amount. Unless the net investment income or modified adjusted income exceeds the threshold amount, the 3.8% tax will not apply. These illustrations demonstrate how the surtax applies.

Illustration 1: Mike is a single taxpayer and has wages of \$150,000 and net investment income of \$30,000.

The MAGI is \$180,000, which is under the threshold amount. Therefore, the 3.8% tax does not apply.

Illustration 2: Assume the facts are the same as Illustration 1, except Mike has wages of \$300,000. In this illustration the modified adjusted gross income is \$330,000. Since the surtax is 3.8% of the lesser of (1) net investment income (\$30,000) or the excess amount of MAGI and the threshold amount (\$130,000), the surtax is \$1,140 (\$30,000 multiplied by 3.8%).

How does it affect Real Estate Professionals?

Generally income from rental property, regardless of participation levels, is considered derived from a passive activity and would be subject to the 3.8% tax. However, there is an exception. A taxpayer that qualifies as a real estate professional and demonstrates material participation in its rental real estate activity may treat the activity as non-passive and exclude the income from the 3.8% tax. To qualify as a real estate professional under section 469(c)(7)(B), the taxpayer must meet these two requirements:

1. More than half the personal services performed by the taxpayer in all trades and businesses were performed in real property trades or business the taxpayer materially participated.
2. The taxpayer performed more than 750 hours of services during the tax year in real property trades or business in which the taxpayer materially participated.

Once the real estate professional standards are met, the taxpayer must demonstrate material participation in the activity of renting real estate. The taxpayer must meet one of the seven tests under Treasury Regulations § 1.469-5T. The most common test is the participation of more than 500 hours in that activity. The material participation requirement must be met for each of the taxpayer's rental activity unless the taxpayer elects to group all of his activities as one single activity.

The original proposed regulation stated that "real estate professionals involved in rental activities were not necessarily considered to be engaged in a trade or business." This created many uncertainties as to whether real estate professionals that materially participate in rental activities would be able to exclude their rental income from the net investment income tax. However, the final regulations did adopt the safe harbor test for certain real estate professionals. The safe harbor test provides that if a real estate professional participates in one or more rental real estate activities for more than 500 hours per year, or for more than 500 hours in any 5 of the preceding 10 taxable years, then the rental real estate activities will qualify. The two tests provided to satisfy the safe harbor test are part of the seven tests to determine material participation. Satisfying the material participation hurdle without meeting these two tests is possible, but is beyond the scope of this article.

If the safe harbor test is met, real estate professionals can exempt their rental activities from the 3.8% tax. To help meet the safe harbor test, real estate professionals may elect to combine the rental real estate activities into one single activity. However, the facts and circumstances of each taxpayer's situation should be carefully analyzed to determine whether or not the safe harbor test applies. Tax planning is necessary if the taxpayer's projected income is expected to exceed the 3.8% tax threshold amounts.

In prior years, real estate investors were inclined to elect real estate professional status to take losses that would otherwise be limited or disallowed. With the 3.8% tax, many real estate investors are affected by this tax increase and determining whether the 3.8% tax applies, can be an important tax planning tool. Because the real estate professional and passive activity rules can be complex, consulting your tax professional is strongly advised.