RENTAL REAL ESTATE TRADE OR BUSINESS— THE NIIT AND BEYOND

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The net investment income tax Section 1411 has made it all the more important to determine exactly when real estate constitutes a trade or business.

The net investment income tax (NIIT) of Section 1411 has increased the importance of determining exactly when a taxpayer's rental real estate constitutes a trade or business (hereinafter, a "T or B") rather than merely an investment.[1] Only if a taxpayer holds rental real estate for use in a T or B can the taxpayer possibly avoid the 3.8% NIIT on rental income.

Section 1411 uses the phrase "trade or business" seven times. It does not, however, bother to define the term. The final NIIT regulations declare that for purposes of the NIIT, "[t]he term trade or business refers to a trade or business within the meaning of section 162."[2] Section 162 provides a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Unfortunately, Section 162 also fails to define a T or B. Indeed, Sections 1411 and 162 are among numerous Code sections and regulations that use the term but fail to define it.[3] The difficulty of defining a T or B was acknowledged by the Seventh Circuit in *Groetzinger:*

> The determination of what constitutes a 'trade or business' under the various provisions of the Code has proven to be most difficult and troublesome over the years. Although the term appears frequently in numerous provisions of the Code it has not been defined by either the Code or the Treasury regulations, nor has any authoritative judicial definition of the terms evolved.[4]

The following discussion is Part 1 of a two-part article. Part I will examine the case law on determining T or B status and whether that case law supports the stringent standards under the regulations on T or B status for purposes of the NIIT. Part II, which will appear in a future issue of *Real Estate Taxation,* will focus on the NIIT regulations and identify the narrow paths to avoidance of the NIIT under the passive activity loss (PAL) rules of Section 469.

Summary

Part I of this article begins with the Supreme Court's *Groetzinger* decision, which provides "common sense" authoritative guidance on the determination of T or B status under Section 162. In doing so, the Court emphasized the importance of the facts in each case. Regrettably, the facts of *Groetzinger* did not involve rental real estate. In order to understand the T or B test for rental real estate, numerous other judicial decisions must also be examined. Discussion of that case law is divided into five fact patterns:

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- *Attempted rentals.* The attempted rental decisions reveal how little rental management activity by a landlord can result in a T or B in the opinion of the Tax Court.
- *Single commercial building rental.* In *Fackler*,[5] both the Board of Tax Appeals (BTA) and the Sixth Circuit agreed that the taxpayer's rental activity, which involved a six-story commercial building, was a T or B. The Sixth Circuit articulated a somewhat more demanding legal standard than the BTA
- *Rentals in which the tenant operates the building.* If, pursuant to the terms of the lease, the tenant is responsible for the complete operation of the building, then the judicial decisions treat the real estate as mere ownership of an investment and not as a T or B. Even if the landlord retains some minor responsibilities, the rental may be determined to be an investment.
- *Rental of a single-family residence.* With facts involving a lone single-family residence rental, the Tax Court and Seventh Circuit will easily find a T or B. On the same facts, however, T or B status may be unachievable in the Second Circuit. This conflict is examined in some detail with a hypothetical case discussed further below.
- *Rentals of multiple properties.* Cases involving the determination of T or B status for taxpayers with multiple rental properties are relatively uncontroversial judicial decisions. Due to the extensive management activity normally present, conflicts in the legal standards are blurred, and all courts generally agree that a T or B exists.

Several relatively recent Seventh Circuit decisions all applying *Groetzinger* and interpreting the phrase "trade or business" have surfaced under the federal labor law (Title 29 of the U.S. Code). Because the labor law decisions specifically address the application of *Groetzinger* to rental real estate, these cases are potentially relevant to the Section 162 T or B test.

Part I ends with an examination of the Service's interpretation of the pertinent judicial decisions. The NIIT regulations purport to rely on existing case law to establish T or B status for purposes of the NIIT, but the regulations, particularly in the Preamble, imply a legal standard that is more demanding than the case law. If IRS agents enforce the tougher IRS standard suggested by the NIIT regulations, numerous disputes with taxpayers are likely to occur, and not only with respect to Section 1411.

Part II, the next installment of this article, focuses on the NIIT regulations and identifies the narrow paths to avoiding the NIIT with rental real estate. The NIIT potentially applies to both the annual net rental income and gain on the disposition of the property.[6] Avoidance of the NIIT requires the rental to be a T or B, and the income or gain to be nonpassive under the passive activity loss (PAL) rules of Section 469.[7] PAL rules that allow rental real estate to generate nonpassive income or gain include:

- *Real estate professionals.* Rental real estate owned by a real estate professional who satisfies the conditions in Section 469(c)(7) is not per se passive. If the real estate professional materially participates in the rental real estate activity, the activity is nonpassive.[8]
- *Self-rentals.* When the taxpayer rents property for use in an entity (partnership, C corporation, or S corporation) owned in whole or in part by the taxpayer, and the taxpayer materially participates in the entity, the otherwise passive net rental income or gain is recharacterized as nonpassive pursuant to Reg. 1.469-2(f)(6). The NIIT final regulations respect this PAL recharacterization rule for self-rentals.[9]
- *Rental/nonrental grouping.* If a self-rental is properly grouped with a nonrental trade or business activity pursuant to Reg. 1.469-4(d)(1), and the taxpayer materially participates in the grouped activity, the activity is nonpassive.
- *Short-term rentals.* Property rented out for periods averaging seven days or less are treated as nonrentals under the PAL rules. Therefore, the activity is not per se passive. If the taxpayer materially participates in such a short-term rental, the activity is nonpassive.[10]
- *Developers.* Under the PAL regulations, a rental may be viewed as incidental to real estate de-

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1 Section 1411 was added to the Code as part of the Health Care and Education Reconciliation Act of 2010. First effective in 2013, it applies to individuals, trusts, and estates.

2 Reg. 1.1411-1(d)(12).

3 *Groeztzinger*, 771 F.2d 269, 56 AFTR2d 85-5683 (CA-7, 1985), *aff'd* 480 U.S. 23, 59 AFTR2d 87-532 (1987). According the Supreme Court's opinion, the "trade or business" phrase "is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations."

4 *Groeztzinger*, *supra* note 3 at 56 AFTR2d 85-5685.

5 45 BTA 708, (19) *aff'd* 133 F.2d 509, 30 AFTR 932 (CA-6, 1943).

6 Sections 1411(c)(1)(A)(i), (ii), (iii).

7 See Sections 1411(c)(1), (2); Reg. 1.1411-5(b)(ii).

8 Regs. 1.1411-5(b)(1)(ii), 1.469-9.

9 Reg. 1.1411-5(b)(2)(i).

10 Reg. 1.1411-5(b)(1)(ii), Temp. Reg. 1.469-1T(e)(3)(ii)(A).