RENTAL REAL ESTATE TRADE OR BUSINESS—THE NIIT AND BEYOND, PART II

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The net investment income tax (NIIT) applies to individuals', trusts', and estates' rental real estate income and sale gain on property held for investment.[1] Only rental real estate held for use in a trade or business (T or B) can escape the NIIT, but the income or gain must also be nonpassive under the rules and regulations of Section 469 in order for it to do so.[2]

The distinction between a T or B and an investment in rental real estate, which is based entirely on judicial decisions, was explored in detail in Part I of this article.[3] Part I concludes that based on case law, remarkably little management activity is needed to establish a T or B. The NIIT regulations, however, while purporting to rely on case law to establish T or B status, imply a legal standard that is more demanding than the strictest judicial precedent.

This installment shifts focus to the NIIT and identifies the narrow circumstances in which rental real estate income is nonpassive and thus, if also from a T or B, avoids the NIIT. Also discussed below are several safe harbors, each tied to a specific type of nonpassive rental income, in which the NIIT regulations deem the rental property to be a T or B. In addition, the article critiques the safe harbor for real estate professionals, which relies on the over-500-hour material participation test as a proxy for T or B status. The author's view, detailed below, is that the T or B safe harbor should be broadened to include any taxpayer who can satisfy any one of the seven material participation tests for the rental real estate in the passive loss rules of Section 469.

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In certain narrow circumstances, rental real estate income is nonpassive and thus, if it is from a trade or business, avoids the NIIT.

NIIT incorporates PAL rules

The NIIT relies exclusively on the PAL rules to establish if the income or gain is passive or nonpassive.[4] For a nonrental business, the activity is nonpassive if the taxpayer materially participates in the activity, and the PAL regulations establish seven tests to determine taxpayer material participation.[5] Conversely, a rental real estate activity is per se passive.[6] Whether or not the taxpayer materially participates in the activity, rental income is passive. In order to escape the NIIT for a rental real estate T or B, the taxpayer must qualify for an exception from the per se rule. The PAL rules and regulations contain several such exceptions. Following is a discussion of each exception, including, where available, the NIIT T or B safe harbor incorporated into the exception.