MP&S REAL ESTATE ADVISOR SEPTEMBER 2013: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS

WILL YOU BE ON THE HOOK? TACKLING THE NEW MEDICARE TAX AND RENTAL ACTIVITIES

The new 3.8% net investment income tax (NIIT), also known as the Medicare contribution tax, gives some taxpayers with rental income yet another reason to seek status as a "real estate professional." This article gives examples of net investment income and explains that those who qualify as a real estate professional *and* materially participate in the business can offset nonpassive income with rental losses. This article also explains how taxpayers who own multiple rental properties can establish material participation.

By now, you've heard about the new 3.8% net investment income tax (NIIT), also known as the Medicare contribution tax. It was created by the Health Care and Education Reconciliation Act of 2010 and took effect at the beginning of 2013. The onset of the NIIT gives some taxpayers with rental income yet another reason to seek status as a "real estate professional."

Summing up the new tax

Beginning this year, higher-income taxpayers generally will be subject to the 3.8% NIIT on some or all of their unearned income, including income from some real estate activities and transactions. This is in addition to — and calculated separately from — the taxpayers' regular income tax or alternative minimum tax (AMT) liability.

NIIT will be applied to net investment income to the extent that modified adjusted gross income (MAGI) exceeds the following thresholds: $250,000 for joint filers; $125,000 for married taxpayers filing separately; and $200,000 for single individuals and heads of households. Individuals who are exempt from Medicare taxes may nonetheless be subject to the NIIT if they have both net investment income and MAGI above the applicable thresholds.

Net investment income is calculated by deducting from investment income certain expenses that can be allocated to that income. Investment income includes (but isn't limited to):

- Interest,
- Dividends,
- Capital gains,
- Rental and royalty income,
- Nonqualified annuities (including payments under life insurance contracts),
- Income from businesses involved in the trading of financial instruments or commodities, and
- Income from businesses that are passive activities to the taxpayer (meaning the taxpayer doesn't "materially participate" in the business).

Such income is excluded from net investment income if it's derived in the ordinary course of a trade or business that isn't considered to be a passive activity with respect to the taxpayer filing the income tax return.

Following the rules

“Passive activity” is defined as any trade or business in which the taxpayer doesn’t materially participate. Rental real estate activities are usually considered passive activities regardless of whether you materially participate.

But the Internal Revenue Code (IRC) recognizes an exception from restrictions on deducting passive activity losses for taxpayers who are real estate professionals. If you qualify as a real estate professional *and* materially participate, your rental activities are treated as a trade or business, and you can offset nonpassive income with your rental losses. You may also be able to enjoy the added benefit of avoiding the NIIT as long as you’re engaged in a trade or business with respect to the rental real estate activities (that is, the rental activity isn’t incidental to a nonrental trade or business).

You can qualify as a real estate professional by satisfying two requirements: 1) More than 50% of the personal services you performed in trades or businesses are performed in real property trades or businesses in which you materially participate, and 2) you perform more than 750 hours of services per year in real property trades or businesses in which you materially participate. “Real property trades or businesses” include those that develop or redevelop, construct or reconstruct, acquire, convert, rent, operate, manage or broker real property.

What counts as material participation? According to the IRC, you materially participated in a rental activity if you satisfy one of the following tests:

- You participated in the activity for more than 500 hours during the tax year.
- Your participation for the tax year constitutes substantially all of the participation in such activity of all individuals for the year.
- You participated in the activity for more than 100 hours during the tax year, and at least as much as any other individual who participated in the activity for the year.
- You materially participated in the activity for five of the 10 immediately preceding tax years.
- Based on all the facts and circumstances, you participated in the activity on a regular, continuous and substantial basis during the year.
- The activity is a significant participation activity, and you participated in such activities for more than 500 hours. (A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you didn’t satisfy any of the five other tests above.)

You can satisfy the test for material participation by electing to aggregate all of your rental activities, often a necessary step, as described below.

Can you prove it?

Under federal tax regulations, you can establish the extent of your participation in an activity “by any reasonable means.” Reasonable means include indentifying and documenting the services performed over a period of time, including the approximate number of hours spent performing those services based on appointment books, calendars or narrative summaries. While contemporaneous records aren’t required, having them will most likely help you withstand IRS scrutiny.

Aggregation to the rescue

Taxpayers who own multiple rental properties may find it difficult to satisfy the material participation requirement for each individual property. Fortunately, the IRC allows you to establish material participation by electing to aggregate all rental properties as a single rental activity. The election will be binding for all future tax years in the absence of a material change in facts and circumstances.

Note that the Treasury Department and the IRS have determined that taxpayers should be given the opportunity to regroup in light of the net investment income tax. Thus, proposed regulations for the new tax provide that taxpayers may regroup their activities in the first taxable year beginning after Dec. 31, 2012, in which the taxpayer meets the applicable income threshold and has net investment income.

THE TAX COURT RULES FOR TAXPAYER IN SELF-RENTAL RULE CASE

Those who rent property to their own business risk catching the eye of the IRS. But this article discusses one case in which the Tax Court found that the self-rental rule didn't apply and the IRS shouldn't have recharacterized the rental income as nonpassive in the first place. With the introduction of the new 3.8% tax on net investment income — which applies to certain passive income — it's more critical than ever for taxpayers to properly identify their passive activities.

If you rent property to one of your own businesses, you probably understand that you'll risk catching the eye of the IRS. That's exactly what happened to one taxpayer who leased property to his wholly owned S corporation. The good news? The Tax Court found that the self-rental rule didn't apply and the IRS shouldn't have recharacterized the rental income as nonpassive in the first place.

The rental arrangement was relevant

Frank Dirico leased land with telecommunications towers to Industrial Communications and Electronics, Inc. (ICE), his wholly owned S corporation, in exchange for a percentage of ICE's revenues from its leases of tower access to third parties. ICE was engaged in a variety of radio-related activities, including construction of -and leasing access to- telecommunications towers, sales and servicing of Motorola radios, and providing specialized mobile radio services for a monthly subscriber fee. ICE constructed towers both for unrelated parties and for its own use in leasing to customers.

ICE's tax returns for the relevant years reported all of its total net income as ordinary business income. On the Schedule K-1 it issued to Dirico as shareholder, ICE also reported his 100% distributive share of its income as ordinary business income; Dirico reported his share of ICE's income for the years as ordinary, nonpassive income. But he reported the income and losses from his leases to ICE as passive activity rental activity.

The IRS applied the self-rental rule to recharacterize Dirico's income from profitable rentals of towers and/or land as nonpassive income, meaning his passive activity losses from nonprofitable rentals couldn't offset the profitable rentals. The self-rental rule applies to net rental income if the property is rented for use in "a trade or business" (which, for purposes of the rule, is an activity other than a rental activity) in which the taxpayer materially participates. Dirico challenged the IRS's finding in the Tax Court.

The Tax Court weighs in

The IRS contended that ICE's tower access rental activity must be considered part of its overall trade or business activity. It relied principally on ICE's grouping of all of its activities and reporting of the related income as nonpassive ordinary business income on its tax returns and Schedules K-1 for the relevant years. The IRS claimed that Dirico was bound by this characterization — not just for his share of ICE's income but also for his rental income.

But the Tax Court found that ICE's mischaracterization of its tower access rental income from third parties (as ordinary business income) didn't control the application of the self-rental rule when the rule was inapplicable — because the towers weren't in fact used in ICE's trade or business. It held that ICE's leasing of tower access to third parties was clearly a rental activity.

It's more important than ever

The new 3.8% tax on net investment income, which applies to certain passive income, makes it more critical than ever for taxpayers to properly identify their passive activities. Your financial advisor can help.

ASK THE ADVISOR

HOW CAN I GIVE REAL ESTATE TO A CHARITY?

Several options are available for giving real estate to charity. Each option can produce a charitable tax deduction and help save on taxes. Some options could even leave the donor with an income stream for a period of time. This article takes a look at outright gifts, bequests, charitable remainder trusts and "bargain sales."

Whether driven purely by charitable motivations or because you also wish to divest yourself of nonproductive assets, you've several options available for giving real estate to charity. Each option can produce a charitable tax deduction and help you save on taxes. Some options could even leave you with an income stream for a period of time.

Outright gifts

As the name suggests, outright gifts transfer ownership to the charity immediately. Such a transaction doesn't trigger capital gains taxes.

To claim the charitable tax deduction based on the value of the property, you must obtain a valuation from a qualified appraiser, no earlier than 60 days before the date of donation. And, if the donation exceeds $5,000, the charity must acknowledge receipt of the property on the applicable tax form.

Note, too, that the tax deduction for giving appreciated property that's been held long term is generally limited to 30% of adjusted gross income for individual taxpayers and 10% of net income for corporations. You can, however, carry over the excess tax deduction for the next five years. Limitations on state tax deductions also apply in some states.

Bequests

Bequests aren't immediate contributions, instead bequests are made in a will and occur after the taxpayers death. A bequest can be:

- Specific — for example, it identifies a specific piece of property for a specific charitable beneficiary,
- Contingent — it occurs only if a condition, such as the spouse predeceasing the donor, is met, or
- Residual — the charity receives a portion or all of what remains in the estate after other bequests, debts, expenses and taxes are paid out of the estate.

Bargain Sale

You can also sell property to a charity at less than fair market value in a "bargain sale" and get a partial charitable contribution deduction . The basis of the property sold to a charity for less than its fair market value must be allocated between the portion of the property “sold” and the portion “given” to charity, based on the fair market value of each portion. Thus, the seller-donor realizes some taxable gain even if the selling price does not exceed the seller-donor’s cost or other basis for the entire property.

Income-producing options

Several arrangements will allow you to receive an income stream, including retained life interests, charitable gift annuities and charitable remainder trusts (CRTs). With a CRT, you deed the property to an irrevocable trust and receive an income stream for your life or a term of years. Upon your death, the charity assumes title to the property.

Choose carefully

The appropriate donation vehicle will depend on your individual goals and circumstances . It’s important to work with your financial advisor who can provide valuable input in determining the best way to structure donations of real estate.

SPOTLIGHT ON MP&S

JNF HOLDS SUCCESSFUL EVENT

The Jewish National Fund’s (JNF) 6th Annual Long Island Golf and Tennis Classic was a resounding success. We were delighted that so many members of the extended MP&S family participated in this year’s event, which honored MP&S Real Estate Group Leader William H. Jennings. We would like to thank everyone for their support. Proceeds from the event benefit JNF’s work with the Central Arava Medical Center. To learn more, please contact Howard Ingram of the JNF directly by phone at 516.678.6805 ext. 110 or by email at hingram@jnf.org.

MP&S HOLDING PRIVATE FOUNDATION SEMINAR ON OCTOBER 17

Together with AMG National Trust Bank, MP&S will be hosting a seminar on the responsibilities of private foundation boards and their management in our Manhattan headquarters on Tuesday, October 17 beginning at 8:30 a.m. For more information or to register, please contact Kelly Parkhurst of MP&S by phone at 212.710.1778 or by email at kparkhurst@markspaneth.com.

DOING BUSINESS GUIDES

Doing business around the world presents a variety of challenges. Morison International (MI), the association of independent accounting and consulting firms of which we are a member, has added Russia and Indonesia to its series of *Doing Business Guides*.

These guides can be found in the Library on the MP&S website. Each guide is written by the MI member firm in the country that is being profiled and provides an introduction to foreign investors on the various aspects of doing business.

FOR FURTHER INFORMATION

If you have any questions, please contact **William Jennings,** Partner-in-Charge of the **Real Estate Services Group** at 212.503.8958 or wjennings@markspaneth.com or any of the other partners in the MP&S Real Estate Services Group:

- Timothy Andrews
  tandrews@markspaneth.com
- Vincent Barra
  vbarra@markspaneth.com
- Patrick Coccodrilli
  pcoccodrilli@markspaneth.com
- Bradley Eckstein
  beckstein@markspaneth.com
- Kurt Kiess
  kkiess@markspaneth.com
- Harry Moehringer
  hmoehringer@markspaneth.com
- Susan Nadler
  snadler@markspaneth.com
- Dawn Rhodes
  drhodes@markspaneth.com
- Michael Saul
  msaul@markspaneth.com
- Abe Schlisselfeld
  aschlisselfeld@markspaneth.com
- Michael Siino
  msiino@markspaneth.com
- Howard Warshaw
  hwarshaw@markspaneth.com

Additional information on the Marks Paneth & Shron Real Estate Services Group can be found at www.markspaneth.com**.**

IRS CIRCULAR 230 DISCLOSURE
Treasury Regulations require us to inform you that any Federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.