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

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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.

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