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Taming the Three-Headed Monster: FICA, SECA, and NIIT Applied to Real Estate Activities

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INTRODUCTION. The ancient Greeks believed that a three-headed, dog-like beast named Cerberus guarded the underworld. Hercules was fabled to have tamed the beast in the most difficult of his 12 labors.

The three-headed beast of the Code[1] consists of the Federal Insurance Contribution Act (''FICA'') tax, Self Employed Contributions Act (''SECA'') tax and Net Investment Income Tax (''NIIT''). These provisions form a ''parallel'' income tax system that attacks from three directions. No income is subject to all three taxes (or even two), but almost all types of income are subject to at least one of the taxes. Avoiding all three can be a Herculean feat.

This article provides an overview of FICA, SECA, and NIIT in the context of real estate activities, with an emphasis on the application to flow-through entities.[2] We focus the analysis in Part II on the treatment of passive versus active investors. Passive investors may qualify for the ''limited partner'' exception to SECA, but it will be difficult for a passive investor to establish the ''material participation'' that is necessary to avoid NIIT. As discussed in Part III, the analysis is more complicated for rental income, which may be entitled to a carve-out from SECA, but a taxpayer is often required to establish status as a ''real estate professional'' to avoid NIIT.

I. BACKGROUND ON TAX REGIMES

A. FICA Tax

FICA is a United States federal employment tax imposed on both employees and employers to fund federal programs designed to provide benefits for retirees, disabled individuals and children of deceased workers. FICA consists of two parts: Old Age, Survivors and Disability Insurance (''OASDI''), which equals 6.2% of an employee's wages;[3] and Hospital Insurance (''HI''), which equals 1.45% of an employee's wages.[4] An employer must withhold and pay FICA tax on its employees' wages, and make a matching payment equal to the amount withheld.[5]

Generally, all wages derived from employment are subject to FICA tax. The term ''wages'' is defined broadly to include ''all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.''[6] As a general rule, payments or benefits from an employer to an employee are considered ''wages'' unless a statutory exception applies.[7] However, wages subject to the OASDI portion of FICA taxes do not include amounts paid to an employee that are in excess of the OASDI taxable wage base.[8] The OASDI wage base is recomputed each year. The 2015 OASDI wage base is $118,500, up from $117,000 in 2014. The HI portion of FICA taxes has no such wage base, and therefore all wages are subject to the HI portion.

Starting in 2013, an ''additional Medicare tax'' of 0.9% applies to an individual's wages over $250,000 for married joint filers.[9] Combined with the HI portion of FICA, the total tax is 3.8% for individuals over the income threshold.

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[1] References to the ''Code'' are to the Internal Revenue Code of 1986, as amended.

[2] This article is not intended as a comprehensive discussion of the FICA, SECA, and NIIT tax law. Rather, it covers selected topics that are frequently encountered by real estate investors and professionals.

[3] §3101(a). Unless otherwise indicated, all references to ''§'' are to sections of the Internal Revenue Code, and all references to ''Reg. §'' are to the Treasury Regulations promulgated thereunder.

[4] §3101(b)(1).

[5] §3111.

[6] §3121(a).

[7] *Id.*

[8] §3121(a)(1).

[9] §3101(b)(2)(A). The additional Medicare tax thresholds are $125,000 for married taxpayers filing separately and $200,000 for single filers. §3101(b)(2)(B), §3101(b)(2)(C).

B. SECA Tax

SECA imposes a tax on the self-employment income of every individual.[10] Like FICA, SECA consists of a 12.4% OASDI portion and a 2.9% HI portion.[11] ''Wages'' that are subject to FICA are specifically excluded from self-employment income.[12] As such, the same income may not be taxed under both FICA and SECA. The OASDI portion of SECA is taxed only up to a threshold,[13] which is $118,500 for 2015.[14] The taxpayer's FICA wages and self-employment income are combined, such that the maximum amount of the combined income that is subject to the OASDI tax is equal to the threshold.[15] There is no cap on the HI portion of SECA. The additional Medicare tax (0.9%) applies when the taxpayer's self-employment income exceeds the $250,000 threshold described above.[16] The taxpayer may deduct 50% of the SECA tax,[17] but the additional Medicare tax is not deductible.

SECA imposes tax on net earnings from self-employment, which is generally defined as gross income derived by an individual from any trade or business carried on by the individual (i.e., generally as a sole proprietorship).[18] The Code has several carve-outs, including most types of rental income, dividends, interest, and capital gains.[19] Flow-through income from an S corporation also is not subject to SECA.[20] However, owners of an S corporation that also perform services must be paid reasonable ''wages'' that are subject to FICA.[21]

According to the IRS, members of a tax partnership may not be employees that receive wages for FICA purposes.[22] Amounts paid to partners by a tax partnership (including a limited liability company (''LLC'') taxed as a partnership)[23] for services rendered in their capacities as partners are treated as guaranteed payments.[24] Per the IRS, such payments are subject to SECA (and not FICA).[25] The treatment of a partner's share of flow-through income is discussed in more detail in II.A below.

C. NIIT

Beginning January 1, 2013, ''high-income'' individuals, estates, and trusts are subject to a 3.8% tax on their ''net investment income.''[26] NIIT applies to the lesser of a taxpayer's (1) net investment income or (2) modified adjusted gross income in excess of a threshold amount (generally $250,000 for married taxpayers filing a joint return or $200,000 for single taxpayers).[27] Income that is subject to SECA under §1401(b) is not included in net investment income.[28] In many respects, the 3.8% NIIT runs parallel to the combined 3.8% HI and ''additional Medicare tax'' of the FICA and SECA regimes.

''Net investment income'' is defined to include the following:

1. Gross income from interest and dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of an ''active trade or business.''
2. Other gross income derived from a trade or business other than an ''active trade or business.''
3. Net gain attributable to the disposition of property other than property held in an ''active trade or business.''[29]

An ''active trade or business'' is a trade or business that neither is a passive activity with respect to the taxpayer under §469 nor consists of trading financial instruments or commodities.[30] Net investment income is reduced by the deductions that are properly allocable to that income.[31] ''Allocable deductions'' are generally the deductible amounts paid or incurred to produce the items of income and net gain that are subject to NIIT.[32]

D. Interplay of FICA, SECA, and NIIT

FICA, SECA, and NIIT are mutually exclusive taxes that run parallel to each other. Each tax triggers (at least) an additional tax of 3.8% on different types of income of high-earning individuals. However, the circumstances in which such taxes are invoked are

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[10] §1401.

[11] §1401(a), §1401(b)(1).

[12] §1401(b)(2)(B).

[13] §1402(b)(1).

[14] Rev. Rul. 2014-34, 2014-52 I.R.B. 954.

[15] §1402(b)(1).

[16] See n. 9 and accompanying text. The taxpayer must combine his or her wages and self-employment income when determining the amount over the threshold.

[17] §164(f)(1).

[18] §1402(a).

[19] §1402(a)(1)–§1402(a)(3).

[20] Rev. Rul. 59-221, 1959-1 C.B. 225; *Ding v. Commissioner*, T.C. Memo 1997-435, *aff'd*, 200 F.3d 587 (9th Cir. 1999).

[21] Rev. Rul. 74-44, 1974-1 C.B. 287; *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990).

[22] Rev. Rul. 69-184, 1969-1 C.B. 256. *See also* GCM 34001 (Dec. 23, 1968) and GCM 34173 (July 25, 1969). However, the Fifth Circuit concluded that §707(a) allows one person to have dual status as a partner and an employee. *Armstrong v. Phinney*, 394 F.2d 661, 664 (5th Cir. 1968) (ranch partnership argued for deduction of meals and lodging provided as an employer to a partner living on the premises and rendering services).

[23] The references to an LLC throughout this article assume the LLC is classified as a partnership for tax purposes.

[24] Rev. Rul. 91-26, 1991-1 C.B. 184.

[25] §1402(a)(13).

[26] §1411.

[27] §1411(a)(1).

[28] §1411(c)(6); Reg. §1.1411-9(a).

[29] §1411(c)(1).

[30] §1411(c)(2).

[31] §1411(c)(1)(B).

[32] Reg. §1.1411-4(f)(1).

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quite different. Generally, all income generated in the form of ''wages'' paid to an employee will be subject to FICA. The more complicated analysis involves income attributable to an owner of a pass-through entity. An owner may generally avoid SECA if he or she (1) owns S corporation stock (and the owner otherwise receives reasonable compensation that is subject to FICA), (2) owns a partnership interest that qualifies for the ''limited partner'' exception, or (3) is allocated income that is subject to a carve-out, such as the carve-out for rental income. If SECA does not apply, the owner might be subject to NIIT on such income. To also avoid NIIT, an owner generally must ''materially participate'' in the trade or business activity, which might be at odds with a SECA classification as a ''limited partner.'' There is a narrow avenue where an ''active'' owner may avoid all three taxes, but the path is less clear for an LLC, as compared to an S corporation. ''Passive'' individuals with significant income will frequently owe at least one of the three taxes. The interplay of these taxes is summarized in Part IV below.

II. PASSIVE AND ACTIVE INVESTORS IN NON-RENTAL ACTIVITIES

The real estate industry involves numerous types of activities, such as real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing and brokerage. Rental activities in particular are subject to unique treatment under the Code, and flow-through income relating to the same is discussed separately in Part III below. The following discusses when flow-through income relating to non-rental activities is subject to SECA or NIIT.[33]

A. SECA

There are several key exceptions to SECA for income attributable to an owner of a pass-through entity. The clearest exception is flow-through income from an S corporation, as described above. The second exception is less clear. Flow-through income of a ''limited partner'' is not subject to SECA.[34] This ''limited partner'' exception was created before LLCs became widely used, and IRS attempts to provide guidance in the context of LLCs has been less than clear.

A taxpayer's share of partnership income is generally subject to SECA.[35] However, §1402(a)(13) excludes from SECA the distributive share of any item of income or loss of a limited partner. The question is whether an LLC member's distributive share will be eligible for ''limited partner'' treatment. On its face, §1402(a)(13) requires status as a state law limited partner, and absent that strict status, regardless of the passive nonparticipatory nature of an LLC's member relationship with the LLC, the exclusion from self-employment tax would not be available.[36] However, neither the IRS nor the courts have interpreted the statute this narrowly.

The IRS first promulgated proposed regulations on December 28, 1994 to address the self-employment tax treatment of members of an LLC. This regulation was met with criticism and was replaced with Prop. Reg. §1.1402(a)-2 in January of 1997.[37] Neither the IRS nor Congress has issued binding guidance since.

The proposed regulations establish functional tests for determining whether an individual is a limited partner. Specifically, an individual is a limited partner unless the individual:

- has personal liability[38] for debts or claims against the LLC;
- has authority to contract on behalf of the LLC; *or*
- participates in the LLC's trade or business for more than 500 hours during the LLC's tax year.[39]

A specific exception applies to members of ''service'' LLCs. These members may not be classified as limited partners, regardless of whether the requirements of the three tests are met. Thus, if substantially all of the activities of the LLC involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual member who provides services as part of that trade or business will not be considered a limited partner.[40]

If an individual fails only the third test (i.e., more than 500 hours of participation), he or she may still qualify by satisfying one of two exceptions. Under a single-class-of-interest exception, the individual will

[34] §1402(a)(13).

[35] §1402(a).

[36] For example, in Rev. Rul. 58-166, 1958-1 C.B. 324, a taxpayer acquired a passive fractional interest in an oil and gas lease that was held subject to self-employment tax, regardless of his limited involvement in the organization producing the income.

[37] Congress placed a moratorium on the IRS from issuing or making effective final regulations with respect to the definition of a limited partner under §1402(a)(13) before July 1, 1998. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §935, 111 Stat. 788, 882

[38] ''Personal liability'' is tied to the definition in Reg. §301.7701-3(b)(2)(ii), which generally relates to determining whether a member of a foreign entity has liability for the debts of the partnership. The determination is based solely on the statute or law in which the entity is organized, unless the organizational document specifies personal liability. A member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such.

[39] Definition of Limited Partner for Self-Employment Tax Purposes, 62 Fed. Reg. 1702, 1704 (proposed Jan. 13, 1997) (''Prop. Reg. §1.402(a)-2(h)(2)'').

[40] There is an exception, however, for those partners who provide only a *de minimis* amount of services. These partners can still be treated as limited partners if all other conditions are met. However, the term ''*de minimis*'' is not defined for this purpose.

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be treated as a limited partner if other members with ''identical interests'' satisfy all three tests. The other persons who qualify under the three tests must also collectively own a substantial partnership interest (generally, 20% or more).[41] The proposed regulations also allow an individual who owns multiple interests in a partnership to exclude from self-employment income the distributive share of income attributable to his or her limited partner interest. The limited partnership interest must be identical (with respect to rights and obligations) to those persons who qualify as limited partners under the three tests and who own a substantial interest in the partnership as determined immediately after the individual acquires the limited partnership interest.

In a case of ''bad facts make bad law,'' the Tax Court recently addressed the SECA tax treatment of a ''limited liability partnership'' in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*.[42] The partners in *Renkemeyer* attempted to treat essentially all income from a law firm (a personal service business) as a return on capital and exclude it from self-employment tax under §1402(a)(13). In that §1402 does not define the term ''limited partner'' and no final regulations exist that define the term, the court looked to the statute's legislative history for guidance on the scope of §1402(a)(13).[43] The court relied on the language in the legislative history, which indicates that Congress intended to exclude partnership earnings of an ''investment nature'' or a return on capital.[44] The court found that none of the income allocated to the members was earnings of an ''investment nature'' because (1) all of the law firm's revenues were essentially derived from legal services performed by the members, and (2) the members made only nominal contributions to the capital of the partnership.

In another recent case, the Tax Court commented on the application of the ''limited partner'' exception to SECA tax.[45] In *Robucci*, a doctor sought to avoid self-employment tax from his practice by creating multiple entities. His goal was to separate his income from intangible assets from his income from performance of personal services. Citing *Moline Props. v. Commissioner*,[46] the court ''disregarded'' the entity that was created to avoid SECA.[47] However, it expressly rejected the IRS's position that providers of professional services never qualify for the exclusion provided in §1402(a)(13).[48] In considering the argument that a member of a professional service LLC may never qualify for the exclusion under §1402(a)(13), the court noted,

> ''[a]lthough it is apparently respondent's position that profit distributions to service-providing members of a multimember, professional service LLC . . . are never excepted from net earnings from self-employment by sec. 1402(a)(13), . . . the Secretary has yet to issue definitive guidance with respect to that issue, and the law remains in a state of uncertainty.''[49]

Just last year, the IRS addressed the issue in a Chief Counsel Advice Memorandum,[50] in which the Chief Counsel's Office advised that partners in investment management LLC were not ''limited partners'' exempt from SECA tax under §1402(a)(13) where the fees paid for its services are its primary source of income. The LLC, which was formed as a successor to an S corporation, managed a family of investment limited partnerships as a general partner. The members of the management LLC were paid compensation (reported on Form W-2 and presumably subject to FICA) and guaranteed payments (related to health insurance and parking benefits). The balance of the flow-through income was not reported as self-employment income.

The members sought to treat the management LLC similarly to an S corporation. The taxpayers argued that the compensation reported on Form W-2 was reasonable, and that the balance of the flow-through income was not subject to SECA. Interestingly, the Chief Counsel's Office did not address the treatment of the LLC under the proposed regulations. Rather, it relied primarily on *Renkemeyer* and legislative history to advise that the management LLC's income ''is not income which is basically of an investment nature of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to §1402(a)(13).''[51] As such, the members were not ''limited partners'' for purposes of §1402(a)(13).

B. NIIT

An active real estate investor may avoid NIIT on some income, but it will be difficult for a passive investor to achieve this result. NIIT applies to income from a trade or business that is a passive activity with respect to the taxpayer. The ability to avoid NIIT hinges on an individual establishing that (1) his or her real estate activities constitute a trade or business; and (2) such trade or business is not a passive activity as defined by §469.

The determination of whether income is derived in a trade or business is made at the pass-through entity level.[52] Neither §1411 nor the regulations promulgated thereunder define a trade or business for the purpose. Rather, the regulations incorporate the defi-

[41] Prop. Reg. §1.1402(a)-2(h)(4).

[42] 136 T.C. 137 (2011).

[43] *Id.* at 148–150.

[44] *Id.* at 150.

[45] *See Robucci v. Commissioner*, T.C. Memo 2011-19, 2011 WL 240261 (2011).

[46] 319 U.S. at 436, 439 (1943).

[47] *Robucci*, T.C. Memo 2011-19.

[48] *Id.* at *10 n. 11.

[49] *Id.*

[50] CCA 201436049.

[51] CCA 201436049.

[52] Reg. §1.1411-4(b)(2)(ii).

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nition of a trade or business found in §162.[53] Whether an activity constitutes a trade or business for purposes of §162 is generally a factual question.[54] The Supreme Court has established two requirements for an activity to constitute a trade or business: (1) the activity must be conducted for income or profit; and (2) the activity must be engaged in with some regularity and continuity.[55] In the case of multiple pass-through entities, the determination of whether income is derived in a trade or business is made at each entity level, and the income maintains its characterization as it passes through each entity.[56]

The determination of whether income allocated to a taxpayer from a pass-through entity is derived in a trade or business is made at the taxpayer level.[57] Section 469 defines a ''passive activity'' as any activity (1) which involves the conduct of a trade or business, and (2) in which the taxpayer does not materially participate. The Code states that a taxpayer will be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous and substantial.[58] This statutory definition of material participation is not particularly helpful. However, Temporary Regulations interpret this standard by providing that a taxpayer materially participates in an activity if and only if the taxpayer meets any one of the following seven tests:[59]

1. The taxpayer participates in the activity for more than 500 hours during the year.
2. The taxpayer's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including non-owners) for such year.
3. The taxpayer participates in the activity for more than 100 hours during the taxable year and such taxpayer's participation for the year is not less than the participation in the activity of any other individual (including non-owners) for such year.
4. The activity is a significant participation activity and the taxpayer's aggregate participation in all significant participation activities during such year exceeds 500 hours.[60]
5. The taxpayer materially participated in the activity for any five taxable years (whether or not consecutive) during the 10 taxable years immediately preceding the taxable year.
6. The activity is a personal service activity and the taxpayer materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.
7. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous and substantial basis.

With the exception of the seventh test described above, the alternative material participation tests focus on quantitative measures. The key measure is the number of hours of participation by the taxpayer. The Code and regulations provide guidance in this regard. Generally, all hours of participation count during the period in which the taxpayer owns an interest in the activity. If the taxpayer is married, participation by the taxpayer's spouse also counts toward hours of participation.[61] This broad view of participation is subject to two key limitations. First, work done in the taxpayer's capacity as an investor is not counted in determining the taxpayer's hours of participation in the activity unless the taxpayer is directly involved in the day-to-day management or operations of the activity.[62] Second, work done by a taxpayer does not count as participation if it is of a type not customarily done by an owner, and one of the principal purposes for the performance of such work is to avoid the disallowance of losses or credits.[63]

To establish hours of participation, a contemporaneous log is not required; rather, any reasonable means of proof may be sufficient. However, the best practice is to maintain a contemporaneous log to ensure that a taxpayer can substantiate his or her records in the event of an IRS audit. If a log is not available, hours could be substantiated through calendars, emails, and affidavits of individuals involved in the activity.

It is difficult to establish material participation in the case of a limited partnership. A limited partner is not treated as materially participating in activities conducted by the partnership unless the limited part-

[53] Reg. §1.1411-1(d)(12).

[54] *See, e.g., Higgins v. Commissioner*, 312 U.S. 212 (1941).

[55] *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). In the real estate context, the trade or business requirement generally presents more of an obstacle in rental real estate activities. For this analysis, see discussion at III., below.

[56] *See, e.g.,* Reg. §1.1411-4(b)(3) *Ex. 1*. For example, if an individual owns an interest in an LLC that is engaged in a trade or business, and that LLC owns an interest in an LLC that is not engaged in a trade or business, the income that flows through to the individual from the lower-tier LLC retains its characterization as not derived in a trade or business, regardless of the intervening upper-tier LLC.

[57] Reg. §1.1411-4(b)(2)(i).

[58] §469.

[59] Reg. §1.469-5T(a).

[60] A ''significant participation activity'' is defined as a trade or business activity (other than a rental activity) in which the taxpayer would not be treated as materially participating under any of the other six tests, but in which the taxpayer participates for more than 100 hours. Reg. §1.469-5T(c)(1).

[61] §469(h)(5); Reg. §1.469-5T(f)(3).

[62] Reg. §1.469-5T(f)(2)(ii)(A).

[63] Reg. §1.469-5T(f)(2)(i).

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ner can satisfy tests 1, 5, or 6 above.[64] The IRS initially sought to extend this limitation to members of an LLC.[65] The courts, however, generally refused to treat LLC members the same as limited partners for this purpose.[66] In response, the IRS backed off its position and issued proposed regulations to amend the definition of a ''limited interest in a limited partnership.''[67] The proposed regulations define a limited partner for this purpose as a partner of an entity classified as a partnership for federal income tax purposes who does not have rights to manage the entity.[68]

The rules described above provide guidance on how an owner of a pass-through entity can establish material participation in an activity. However, a key to this analysis is to define an activity. The regulations permit a taxpayer to use any grouping of activities that constitutes an ''appropriate economic unit'' for the measurement of gain and loss.[69] The facts and circumstances that have the greatest weight in determining whether grouping of activities constitute an appropriate economic unit include similarities and differences in types of business, the extent of common control, the extent of common ownership, geographical location, and interdependencies between the activities.[70] For activities conducted through a pass-through entity, the grouping of activities must occur at the entity level.[71] The individual owner of the pass-through entity may then group activities conducted through the entity with activities conducted directly or conducted through other pass-through entities.[72] This permits an individual who owns an interest in two LLCs, both of which are involved in real property development, to group the activities performed by both LLCs into an appropriate economic unit. The individual then need only satisfy the material participation test for the grouped activity.

For a passive investor, net gain on the disposition of real property (or on the disposition of an interest in a pass-through entity) will likely trigger NIIT. This will be the case when net gain is attributable to the disposition of property that is either (1) not held in a trade or business or (2) held in a trade or business that is a passive activity.[73] For purposes of this rule, the regulations apply the income tax gain and loss recognition rules to determine net gain.[74] This means that a non-recognition event for income tax purposes (such as a like-kind exchange under §1031) should also be a non-recognition event for NIIT purposes.

There is a ''look-through'' rule in the case of a disposition of an active interest in a partnership or an S corporation. Gain from such a disposition is taken into account for NIIT purposes only to the extent it is attributable to assets of the entity that would otherwise generate NIIT (such as publicly traded C corporation stock held by an S corporation).[75] A similar rule applies to losses.[76] Proposed regulations issued in 2013 calculate the partner or shareholder's net investment income from such a disposition using either a primary method or (if the individual is eligible) an optional simplified reporting method.[77]

III. RENTAL ACTIVITIES

The treatment of rental income involves a more complicated analysis. In the case of rental income, a taxpayer will generally avoid SECA. Section 1402(a)(1) specifically carves out certain real estate rental income from the definition of net earnings from self-employment.[78]

On the other hand, rental income will often be subject to NIIT. Rental income is specifically included in net investment income (unless an exception applies) and is treated as per se passive under §469. As such, gross income derived from a rental real estate activity can avoid NIIT only where (1) it is derived in the ordinary course of a trade or business; and (2) the rental activity is not per se passive because (a) the taxpayer is a real estate professional, (b) the rental income is appropriately grouped with non-rental income, or (c) the rental income is otherwise recharacterized as non-passive.

The trade or business test described above applies whether the real estate activity is a rental or non-rental activity; however, the determination of whether an activity constitutes a trade or business is less clear for rental real estate. The regulations provide one example involving rental real estate in which an individual rents a commercial building to a third party. Such individual is not involved in the activity of the commercial building on a regular and continuous basis, and regulations treat the rental income as not de-

[64] §469(h)(2); Reg. §1.469-5T(e)(2).

[65] *See, e.g., Thompson v. United States*, 87 Fed. Cl. 728 (2009) *acq. in result only*, 2010-14 I.R.B. 515; *Garnett v. Commissioner*, 132 T.C. 368 (2009).

[66] *Id.*

[67] Passive Activity Losses & Credits, 76 Fed. Reg. 72,875, 72,877 (proposed Nov. 28, 2011); Prop. Reg. §1.469-5(e)(3)(i)(B). Management rights for this purpose are determined under state law in the jurisdiction where the entity is organized and the applicable provisions of the governing agreement.

[68] *Id.*

[69] Reg. §1.469-4(c)(1).

[70] Reg. §1.469-4(c)(2).

[71] Reg. §1.469-4(d)(5).

[72] Reg. §1.469-5(d)(5)(i).

[73] *See* Reg. §1.1411-4(a)(1)(iii).

[74] *See, e.g.,* Reg. §1411-4(d)(3)(ii) *Exs.*

[75] §1411(c)(4)(A).

[76] §1411(c)(4)(B).

[77] Prop. Reg. §1.1411-7(b) and Prop. Reg. §1.1411-7(c). These methodologies apply where the taxpayer materially participated in one or more of the pass-through entity's trades or businesses. A detailed analysis of the two methodologies is beyond the scope of this article.

[78] This exception, however, does not apply to rental received in the course of a trade or business as a real estate dealer. A real estate dealer is generally defined as one who holds property primarily for sale to customers. Individuals falling within this classification would have income subject to SECA, unless another exception applies (such as the exception for a limited partner).

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rived from a trade or business. This conclusion without any analysis is not particularly helpful.

The case law analyzing the trade or business standard under §162 provides some guidance, but still leaves the law uncertain. In *Curphey v. Commissioner*,[79] the Tax Court applied the standard in §162 to hold that the taxpayer's rental activities were a trade or business for purposes of §280A where the activities included "personal efforts to manage the six units in seeking new tenants, in supplying furnishings, and in cleaning and otherwise preparing the units for new tenants."[80] Courts have reached a similar conclusion in many cases involving the rental of even a single property.[81] However, it is not the case that rental of real property will always constitute a trade or business. The IRS views the determination as highly factual and requires the taxpayer to be involved with continuity and regularity.[82] Tax professionals commonly view the existence of a triple net lease to be a negative factor for taxpayers seeking to treat their rental activities as a trade or business.

If the rental activity is a trade or business, it must then overcome the per se passive rule. Under §469(c)(2), a rental activity is treated as per se passive without regard to whether the rental activity involves the conduct of a trade or business or whether the taxpayer has materially participated. To avoid this per se passive treatment, a taxpayer must fall within an exception. One key exception is for taxpayers who qualify as real estate professionals. A real estate professional must satisfy *both* of the following two tests: (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during such tax year are performed in real property trades or businesses in which the taxpayer materially participates; and (2) the taxpayer performs more than 750 hours of services during the tax year in real property trades or business in which the taxpayer materially participates.[83]

Classification as a real estate professional simply overrides the per se passive treatment for rental income. As such, a real estate professional must then establish material participation in an activity to avoid subjecting flow-through income attributable to such activity to NIIT. It may seem that a real estate professional would always satisfy the material participation test because he or she had to perform at least 750 hours to qualify as a real estate professional. However, the 750-hour test is based on all activities performed in a real trade or business, and material participation must be met with respect to each specific activity (taking into account grouping).

Section 469(c)(7)(A) states that for real estate professionals, the passive loss rules will be applied as if each interest of the taxpayer in rental real estate were a separate activity. However, a taxpayer can elect to treat all interests in rental real estate as a single activity. A taxpayer's interest in rental real property held through a pass-through entity constitutes a single activity.[84] An exception is where the taxpayer owns, directly or indirectly, a 50% or greater interest in the capital, profits, or losses of the pass-through entity. In that case, each interest in rental real estate will be treated as a separate interest unless the taxpayer makes a grouping election.[85]

The grouping rules contain a second exception to the per se passive rule. Rental income will lose its characterization where the rental activity is grouped with a trade or business activity. Generally, the regulations prohibit grouping a rental activity with a trade or business activity.[86] An exception to this rule exists, however, where one of the two activities is insubstantial in relation to the other. "Insubstantial" is not defined for this purpose, but has been considered by a district court to involve a qualitative and quantitative standard.[87] A second exception to this grouping prohibition is for two activities where (1) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity; and (2) at least a portion of the rental activity involves the rental of items of property for use in the trade or business activity.[88]

A third exception to per se passive treatment is where an item of property is rented to a flow-through entity in which the taxpayer owns an interest. In that case, any income generated by such rental is recharacterized as non-passive income.[89] The recharacterization occurs for each "item of property" and not each rental "activity." This means items of property that generate income will be recharacterized as non-passive, but items of property that generate losses will retain their per se passive nature.[90]

IV. CONCLUSIONS

Real estate projects frequently generate tax losses in early years. These "passive loss generators" can be used to offset passive income and minimize NIIT. Some taxpayers may also minimize NIIT by holding real estate investments through tax-exempt retirement vehicles such as IRAs and Roth IRAs, but these structures hold many traps for the unwary such as "unrelated business income tax" and "prohibited transac-

[79] 73 T.C. 766 (1980).

[80] *Id.* at 775.

[81] *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Elek v. Commissioner*, 30 T.C. 731 (1958); *Lagredie v. Commissioner*, 23 T.C. 508 (1954); *Noble v. Commissioner*, 7 T.C. 960 (1946).

[82] FSA 200120036.

[83] §469(c)(7)(B).

[84] Reg. §1.469-9(h)(1).

[85] Reg. §1.469-9(h)(2).

[86] Reg. §1.469-4(d)(1)

[87] *Glick v. United States*, 96 F. Supp. 2d 850 (S.D. Ind. 2000). Prior temporary regulations contained an 80/20 rule based on relative gross income to determine insubstantiality. Reg. §1.469-4T. This 80/20 rules was eliminated in subsequent temporary regulations, but it may have some continued relevance for planning purposes.

[88] Reg. §1.469-4(d)(1)(i)(C).

[89] Reg. §1.469-2(f)(6).

[90] *See, e.g., Carlos v. Commissioner*, 123 T.C. 275 (2004).

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tion'' penalties. NIIT should not be a significant consideration in the choice of entity analysis for passive investors in most cases. NIIT generally applies to a passive investor's income from a C corporation (e.g., dividends and capital gains), S corporation, LLC, or limited partnership.

For active real estate professionals, SECA, FICA, and NIIT considerations are much more significant in the choice of entity analysis. Given the current uncertainty in the law regarding SECA taxation of LLCs, an S corporation is preferred for an activity that generates fee income (e.g., brokerage, property management, and development fees). The IRS and the courts have recently shown a willingness to impose SECA tax on ''service'' LLC income, even when the owners receive a reasonable salary. For real estate activities conducted through an S corporation, shareholders who are active in the business and are paid reasonable compensation should avoid SECA and NIIT on their allocable share of income.

Another key planning strategy for active investors involves grouping activities. The benefit of grouping is to permit a taxpayer to establish material participation (generally through performance of a certain number of hours of service) in a number of investments. If the investments generate flow-through income, the taxpayer may avoid NIIT. However, this benefit should be weighed against the overall tax planning strategy of the taxpayer. The §469 rules were adopted to prohibit taxpayers from generating losses through a passive investment (i.e., an activity in which the taxpayer does not materially participate) and using such losses to offset income from an active trade or business. If a taxpayer groups his or her activities in a manner to establish material participation and thus avoid NIIT, it may have unintended tax consequences. For example, a grouping election could cause otherwise passive income to be characterized as active income, and the taxpayer may not be able to use ''ungrouped'' passive losses to offset ''grouped'' active income. Once a grouping election is made, the taxpayer generally cannot regroup in a subsequent tax year.[91] As such, a grouping election requires careful consideration.

An LLC (or other entity taxed as a partnership) is almost always the preferred entity to own real estate directly. The partnership tax system is far more flexible and taxpayer-friendly than the S corporation system. For activities that do not involve rental income (such as subdivision and condo developments), real estate professionals should seek to acquire ownership interests that satisfy the ''limited partnership'' exception to SECA. A frequent planning technique is to create multiple classes of interests and have the developer invest in the ''investor class'' on the same terms as passive investors. However, this strategy likely does not work for any ''carried interest'' or profits interest granted to the developer. These interests, which are frequently granted in exchange for services, will often generate SECA tax on non-rental income. In certain situations, it may make sense to hold such interests in an S corporation, although that structure could be subject to an IRS challenge if the structure has no business purpose or if the S corporation is a sham.

Health care is expensive. SECA, FICA, and NIIT are intended, in part, to fund government health care benefits. As such, Congress intended to apply these taxes to almost all types of income. In doing so in a piecemeal manner, however, it has created a three-headed monster. Given that SECA, FICA, or NIIT impacts the vast majority of taxpayers, we would all be well served if Congress simplified this ''parallel'' income tax system.

[91] Regrouping is permitted where (1) the original grouping was clearly inappropriate or (2) there has been a material change in facts and circumstances that makes the original grouping clearly inappropriate. Reg. §1.469-4(d)(4).

APPLICATION OF FICA, SECA, AND NIIT TO REAL ESTATE INCOME[92]

	LLC	LP	S Corp
Non-Rental Activities:			
Passive Activity Under Code Section 469	NIIT. No SECA or FICA.	NIIT. No SECA or FICA.	NIIT. FICA on ''reasonable compensation.''
Non-Passive Activity Under Code Section 469	No FICA or NIIT. SECA unless the ''limited partner'' or another exception applies.	No FICA or NIIT. SECA if ''general partner.''	No SECA or NIIT. FICA on ''reasonable compensation.''
Rental Activities:			

[92] The following provides a brief summary of the overall rules. Each of these general rules is subject to exceptions and special rules.

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	LLC	LP	S Corp
Rental Income — Passive Investor	No FICA. No SECA unless dealer. NIIT.	No FICA. No SECA unless dealer. NIIT.	No SECA. NIIT. FICA on ‘‘reasonable compensation.’’
Rental Income — Real Estate Professional	No FICA. No SECA unless dealer. No NIIT if active.	No FICA. No SECA unless dealer. No NIIT if active.	No SECA. No NIIT if active. FICA on ‘‘reasonable compensation.’’
Rent to ‘‘active’’ business	No FICA. No SECA unless dealer. No NIIT.	No FICA. No SECA unless dealer. No NIIT.	No SECA. No NIIT. FICA on ‘‘reasonable compensation.’’

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