

FICPA Gulf Coast Chapter Annual Meeting
January 7, 2014

**Medicare Surtax Planning for Real Estate
Investors and Developers**

E. John Wagner, II



Medicare Surtax Overview

- Federal wage and self-employment taxes have historically included a 2.9% Medicare tax (the “Historic Medicare Tax”).
- The 2010 Obamacare legislation created two new additional Medicare “Surtaxes” effective in 2013:
 - An additional .9% Surtax on wages and self-employment income in excess of threshold income.
 - A 3.8% Surtax on lower of “Modified AGI” in excess of threshold income or “Net Investment Income.”
 - The thresholds for the Surtaxes are \$250,000, \$200,000, and \$125,000 for taxpayers who file married joint, single, and married separate, respectively, for federal income tax purposes, and \$11,950 for trusts.

Medicare Surtax Overview

Self Employment
Income



.9% Surtax

Net Investment
Income



3.8% Surtax

Medicare Surtax Overview

- IRS published final and proposed regulations December 2, 2013, addressing the Surtaxes.
 - Final regulations address a broad range of subjects, completing proposed regulations published in December 2012 .
 - New proposed regulations address partnership tax-specific and other issue-specific items (to be discussed another day).
- The final regulations provide *some* additional clarity as to structures that may minimize the applicability of the Surtaxes to real estate investors and developers.

Medicare Surtax Overview

- To paraphrase our Vice President, “This is a big deal.” Our clients care. Small percentages add to big dollars, enhancing the pain from income tax rate increases. Clients are stunned when they see the decrease in net after-tax proceeds from liquidity events.
- The scope of the Surtaxes and the planning opportunities to avoid the Surtaxes comprise yet another Byzantine topic in the federal tax law.
- Today we will focus on a few planning opportunities that are time sensitive and specific to real estate investors and developers. Our goal is to provide an overview of fertile planning opportunities to target for further investigation for the appropriate taxpayers. The Holy Grail is avoiding both the .9% Surtax and the 3.8% Surtax.
- Planning to avoid the tax for liquidity events many years in the future must be done (1) on 2013 tax returns, to take advantage of a one-time exemption planning opportunity, and (2) via current business entity and cash flow structuring, to avoid IRS re-characterization of last minute changes in the future.

Medicare Surtax Overview: .9% Surtax

- Directly tied to computation and collection of wages and self-employment income under Historic Medicare Tax.
- Essentially creates a second tax bracket for the Historic Medicare Tax.
- When applicable, .9% Surtax and 2.9% Historic Medicare Tax combine to create a 3.8% marginal tax on wages and self-employment income, matching the Net Investment Income 3.8% Surtax rate.

Medicare Surtax Overview: 3.8% Surtax

- “Lower of” formula limits application to those with both Net Investment Income and Modified AGI in excess of thresholds.
- **Net Investment Income** includes: **passive trade or business income**, interest, dividends, annuity payments, royalties, **rents**, certain trading income, **net gains (both capital and ordinary) from dispositions of property**.
- Unlike .9% Surtax, the 3.8% Surtax creates a new tax regime more akin to an income tax that reaches classes of income not touched or rarely touched by the Historic Medicare Tax.

.9% Surtax: Exemptions

- .9% Surtax can be avoided in the same way as the Historic Medicare Tax. Exemptions include:
 - Capital gains and non trade or business income exempt from 2.9% Medicare Tax.
 - Pass-through income from S corporation stock.
 - Pass-through income from partnership “limited partner” interests under IRC § 1402(a)(13).
 - Including, arguably, certain LLC interests, following the concepts like those enunciated in the 1997 proposed but never finalized self-employment tax regulations.
 - But subject to *Renkemeyer v. Comm’r*, 136 TC 137 (2011) and similar cases.

3.8% Surtax: Active Trade or Business (“ATB”) Exemption

- The 3.8% Tax has a key two-pronged exception for income derived from:
 - An IRC §162 trade or business (not an IRC §212 activity for profit or other activity)
 - That is not passive under the IRC §469 Passive Activity Loss rules.
- Both prongs must be satisfied.
- The exemption is specific to particular items of income in a particular year, not categorical to a taxpayer or to all income in a year. One taxpayer could have some exempt income and some income subject to the 3.8% Surtax in the same year.

3.8% Surtax: Active Trade or Business (“ATB”) Exemption



3.8% Surtax ATB Exemption: “Trade or Business”

- Changing course from 2012 proposed regulations, 2013 final regulations apply IRC §162 “trade or business” definition to 3.8% Surtax exemption, except as specially modified under the regulations. Regs. §1.1411-1(d)(12).
- “Self-charged” Interest, Rent, and Gains
 - 2012 proposed regulations caused concern because they did not deem certain interest and rental income potentially exempt trade or business income for 3.8% Surtax purposes, even if paid from affiliates in trades or businesses.
 - 2013 final regulations adopt self charged interest and rental exclusions matching the respective §469 Passive Activity Loss rules, including with respect to gains from the sale of self rental properties. Regs. §1.1411-1(g)(5), (6).

3.8% Surtax ATB Exemption: “Trade or Business”

- Other Rental Activities:
 - May be a trade or business under §162 test. Regs. §1.1411-4(g)(7)(iii).
 - Even if not under §162, will be deemed a trade or business for 3.8% Surtax purposes if:
 - Taxpayer is §469 real estate professional, and
 - Taxpayer participates (applying §469 Passive Activity Loss standards, including grouping elections) in rental real estate activities for more than 500 hours in the year or in any five of last ten years. Regs. § 1.1411-4(g)(7)(i).

3.8% Surtax ATB Exemption: Not a Passive Activity

- 3.8% Surtax Passive Activity test generally tracks the equivalent IRC §469 rules focusing on hours per year (typically 500) devoted to particular activities.
- Notable unfavorable rules exist for rental real estate activities and limited partner interests (applying a different test than the test for the limited partner exemption to the Historic Medicare Tax and the .9% Surtax), but with planning taxpayers can often successfully navigate these rules.
- “Real estate professionals” who satisfy a 750 hour per year test enjoy greatest leeway.

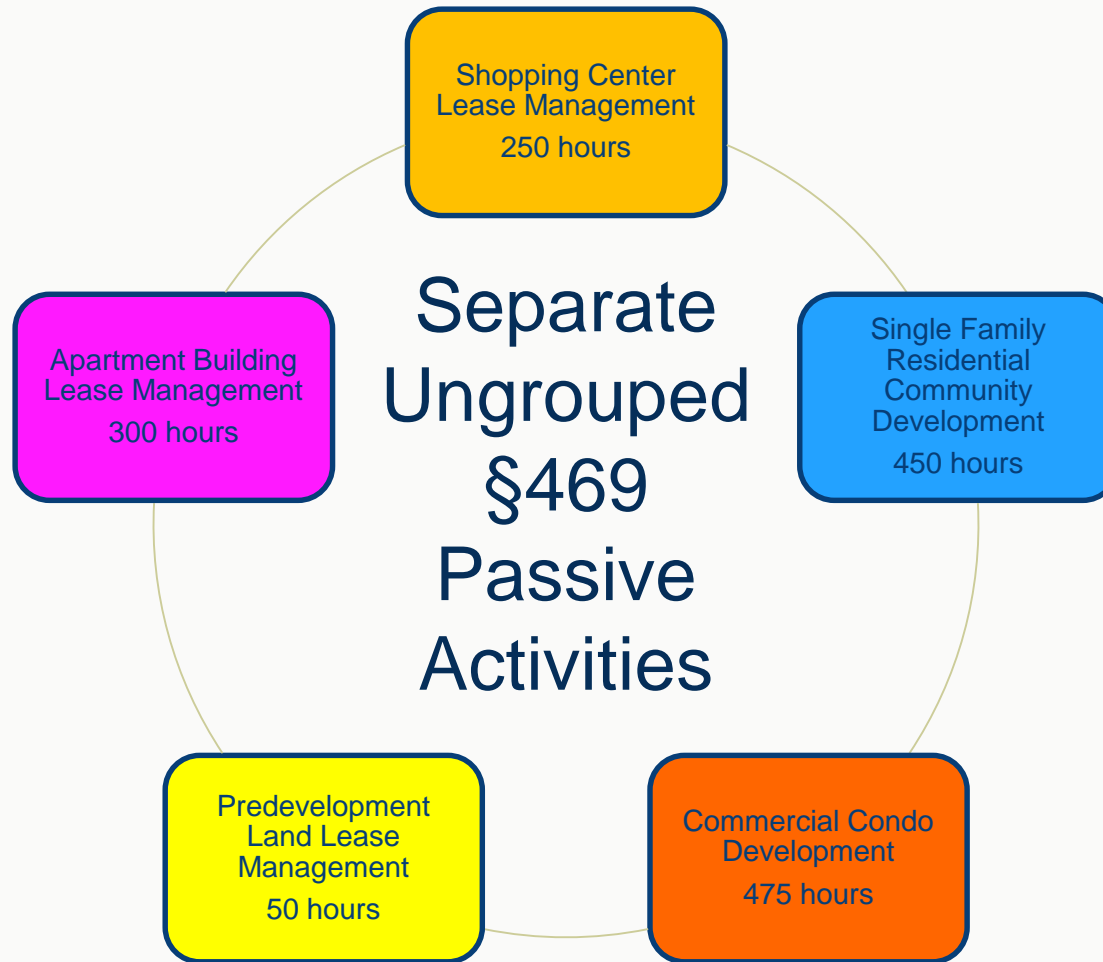
3.8% Surtax ATB Exemption: Not a Passive Activity

- Activity Grouping
 - Subject to special limitations, activities in separate entities may be grouped and therefore treated as one activity for both §469 and the 3.8% Surtax. Revenue Procedure 2010-13 provides disclosure rules and procedures for grouping elections.
 - Once made a grouping election is difficult or impossible to change.
 - **But the 2013 final regulations include a one-time opportunity to change grouping elections on 2013 federal income tax returns.**

3.8% Surtax ATB Exemption: Not a Passive Activity

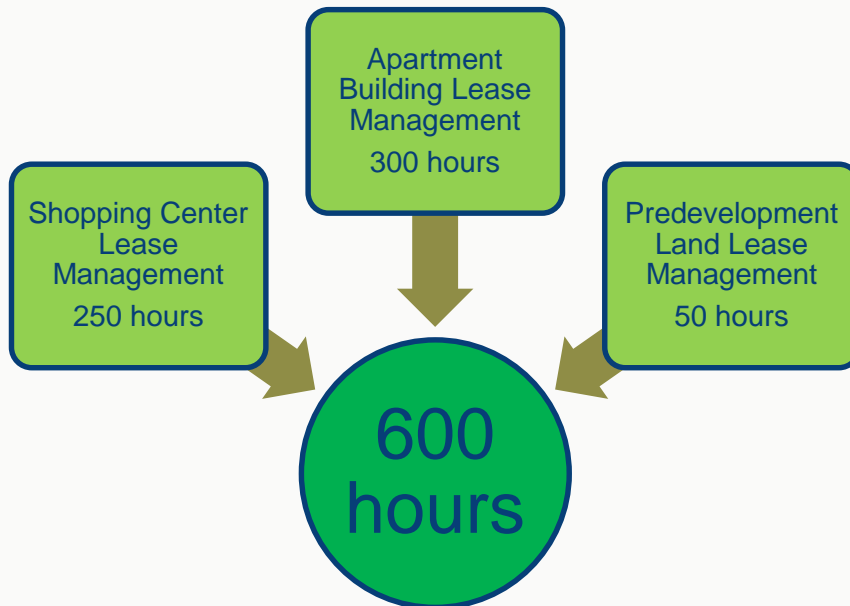
- Activity Grouping
 - To be grouped, activities must comprise an “appropriate economic unit” applying a facts and circumstances test, with emphasis on similarity of business type, common control and ownership, location, and interdependence. See Regs. §1.469-4(c)(2).
 - Special rules exist for farming and real estate rental activities, including rules limiting grouping of these activities with other activities.

3.8% Surtax ATB Exemption: Not a Passive Activity

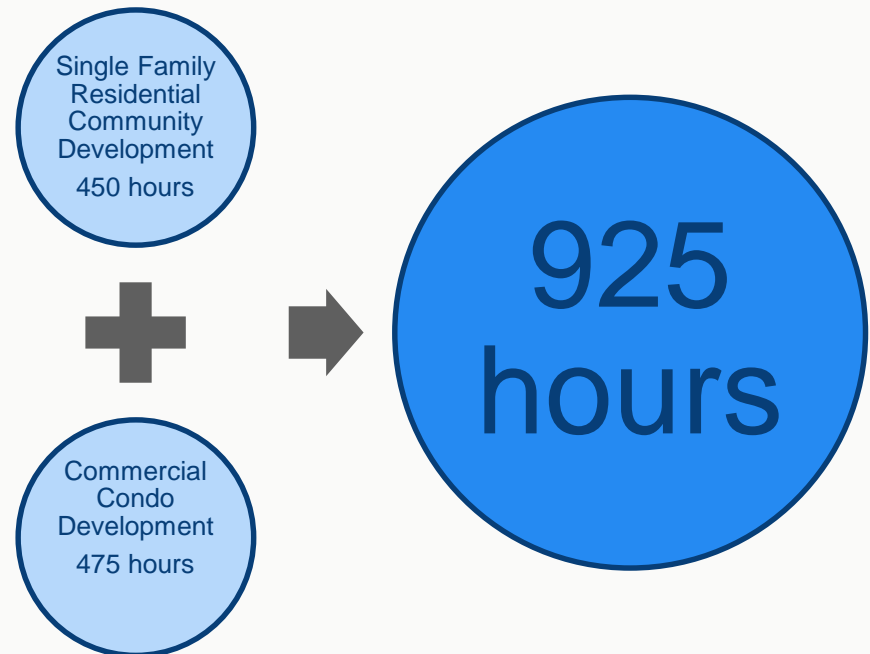


3.8% Surtax ATB Exemption: Not a Passive Activity

Grouped §469 Active Leasing Activities



Grouped §469 Active Developer Activities



Medicare Surtaxes: What to Avoid

- Without planning
 - Dealer and developer ordinary income, rent, IRC §1231 gains and other income may be subject to the 3.8% Surtax, or the .9% Surtax and Historic Medicare Tax.
 - Pure capital gains (excluding §1231 gains) from the sale of raw land will be subject to the 3.8% Surtax.

Medicare Surtaxes: What to Do



Medicare Surtaxes: What to Do

- Dealers, Developers, and Operating Businesses.
 - Avoid the .9% Surtax using ownership structures (S corporations and limited partner interests) traditionally used to avoid the Historic Medicare Tax, paying applicable employment taxes and the .9% Surtax on reasonable compensatory payments.
 - Avoid the 3.8% Surtax by:
 - Grouping activities to make them active under IRC §469.
 - Plan ahead by using the one-time opportunity to regroup on a taxpayer's 2013 federal income tax return.
 - Become a real estate professional for IRC §469 purposes, if possible.
 - Exploit differences in “limited partner” definition under IRC §469 passive activity rules and IRC §1402 self employment tax rules.

Medicare Surtaxes: What to Do

- Land bankers and other raw land investors
 - Avoid the 3.8% Surtax by:
 - Converting holding purpose to rental or farming, such that sale qualifies as IRC §1231 trade or business gain rather than pure capital gain.
 - Grouping rental and farming activities to make them active under IRC §469, being careful with special rules restricting grouping with other activity types.
 - Plan ahead by using the one-time opportunity to regroup on a taxpayer's 2013 federal income tax return.
 - Use the 500 hour leasing safe harbor to satisfy the 3.8% Surtax trade or business test, and become a real estate professional for §469 purposes to avoid passive activity characterization.
 - Avoid the .9% Surtax using ownership structures (S corporations and limited partner interests) traditionally used to avoid the Historic Medicare Tax, paying applicable employment taxes and the .9% Surtax on reasonable compensatory payments.

Medicare Surtaxes: What to Do

- Don't Become an S Corporation Addict
 - The Medicare Surtaxes make S Corporations more attractive than in the past because of:
 - Fewer limitations to establish “active” status under passive activity loss rules, to achieve exemption from the 3.8% Surtax, and
 - Better established self-employment tax exemptions, to also establish exemption from the .9% Surtax.

Medicare Surtaxes: What to Do

- Don't Become an S Corporation Addict
 - But don't forget the good reasons the tax partnership business form remains attractive:
 - With structuring, may be able to replicate Surtax exemptions.
 - Flexibility for special allocations and multiple classes of ownership.
 - Fewer restrictions regarding eligible owners.
 - Less risk of accidentally losing pass-through income tax status.

Medicare Surtaxes: What to Do

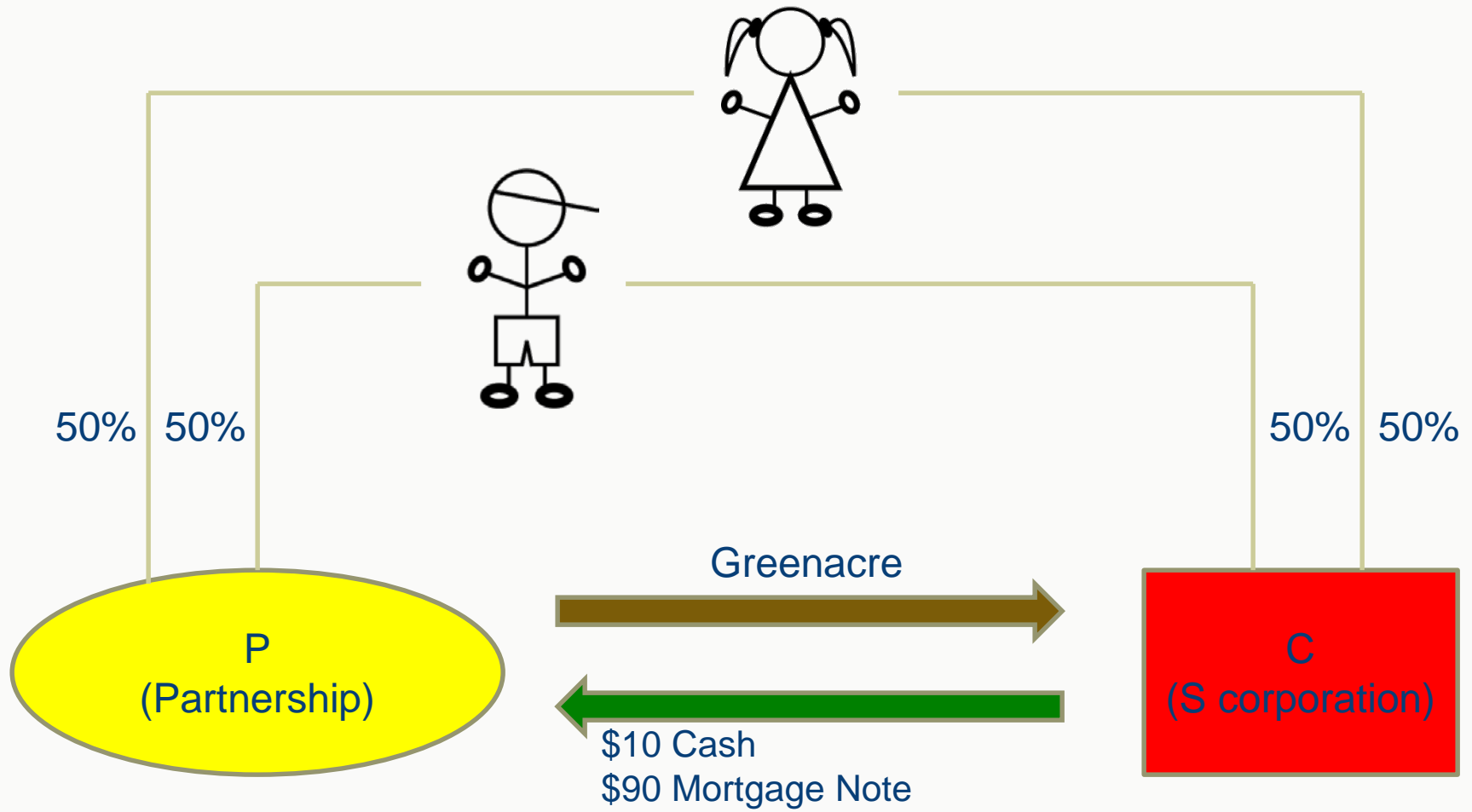
- Don't Become an S Corporation Addict
 - More good reasons the tax partnership business form remains attractive:
 - Inside basis increase on death and with transfers for consideration.
 - Easier to reorganize tax-free, including opportunities for tax-free distributions of appreciated property.
 - §704(c) prevents gain and loss misallocation from contributed property.
 - Others...

Medicare Surtax Example: *Bramblett* Planning

Assume:

- Partnership “P” and Subchapter S Corporation “C” have identical ownership.
- P has held Greenacre, which consists entirely of raw land, as a capital asset for many years. P had a \$10 tax basis in Greenacre.
- P sells Greenacre to C in exchange for \$10 cash payable at closing and a \$90 purchase money mortgage note. The note requires annual interest payments, with the principal and unpaid interest due on its tenth anniversary.
- C intends to develop Greenacre as a single-family residential development. The mortgage includes a lot-sale release price which is proportionate to the price of each lot, as compared to the anticipated selling prices of all the lots to be developed.
- Other transaction terms are arms length.
- P has good business purpose in protecting its other properties from liabilities associated with the development of Greenacre.

Medicare Surtax Example: *Bramblett* Planning



Medicare Surtax Example: *Bramblett* Planning

- Traditional Taxpayer Positions:
 - P recognizes capital gain, deferred under installment method and exempt from Historic Medicare Tax.
 - C recognizes developer or dealer ordinary income.
 - C, an S corporation, makes reasonable compensatory payments subject to employment taxes, but treats the remainder of its income as a shareholder pass through exempt from Historic Medicare Tax.

Medicare Surtax Example: *Bramblett* Planning

- Medicare Surtax Pitfalls
 - 3.8% Surtax on gains from sale of raw land, because holding raw land by itself cannot be a trade or business (even if grouped with a trade or business for IRC §469 purposes).
 - 3.8% Surtax on S corporation shareholder pass throughs from C, if shareholder is not active in C for IRC §469 purposes.
 - .9% Surtax may increase scrutiny of reasonableness of C's compensatory payments subject to employment taxes (including the .9% Surtax).

Medicare Surtax Example: *Bramblett* Planning

- Medicare Surtax Opportunities
 - Manage the 3.8% Surtax by:
 - Causing P to enter the trade or business of farming or leasing during pre-development holding and entitlement period.
 - Grouping P and C activities with other qualifying taxpayer activities, to make both active for IRC §469 purposes, keeping in mind that P's farming or leasing activities are unlikely to qualify for grouping with C's dealer or developer activities.
 - Manage the .9% Surtax by giving extra diligence to reasonableness of C's compensatory payments that preserve S corporation's .9% Surtax and Historic Medicare Tax exemptions on shareholder pass throughs.

Thank You and Happy New Year!

- We hope our presentation has helped you build a Medicare Surtax planning perspective for your real estate oriented clients.
- There are many more details which we have not attempted to flesh out, in the hope of preserving your perspective on the initial questions to ask and opportunities to pursue.
- We are glad to help you help your clients tackle the Medicare Surtaxes.

CIRCULAR 230 DISCLOSURE

To comply with Treasury Department regulations, we advise you that information contained in this presentation cannot be used for the purpose of (i) avoiding penalties imposed by the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any matters addressed herein. This presentation does not create an attorney-client relationship.

Business and Tax Blog: blog.williamsparker.com