

"Landlords" and the Surtax

March 2013

Framing the Issue

Taxpayers who own real estate that produces taxable income (rents that exceed expenses) may end up paying an additional Surtax (3.8% rate) on that income this year. How can this be? The Surtax created under the "Affordable Care Act" is designed to tax the net investment income of certain taxpayers, and rental income (a form of passive investment income) is subject to the Surtax.

Is every landlord who collects rent subject to the Surtax? No. A taxpayer who qualifies as a "real estate professional" earns rental income that is classified as active (non-passive investment) income. This active rental income (of a real estate professional) is not subject to the Surtax. By comparison, the passive rental income of other taxpayers is subject to the Surtax.

Beginning this year, taxpayers who own rental property will review whether they qualify as real estate professionals or whether the Surtax may apply to their rental income.

This discussion will review (1) how the Surtax operates, (2) the history of passive activity loss rules (as they relate to the Surtax) and then (3) how taxpayers may be classified as real estate professionals who otherwise do not pay the Surtax on their rental income.

Explaining the Surtax

The Surtax (3.8% rate) applies to all or part of the **net investment income** of taxpayers whose **modified adjusted gross income ("MAGI")** exceeds a **threshold amount**. The portion of net investment income subject to the Surtax will depend on the amount by which MAGI exceeds the applicable threshold amount.

During the 1980's, Congress enacted rules to curb the use of tax shelters that had become so prevalent then.

The **threshold amount** equals (1) \$250,000 for married taxpayers filing jointly, (2) \$125,000 for married taxpayers filing separately and (3) \$200,000 for all other taxpayers. If MAGI exceeds the threshold amount, the Surtax will reach investment income. If MAGI does not exceed the threshold amount, the Surtax will not apply.

For this purpose, **MAGI** equals the sum of adjusted gross income (Line 37 of IRS Form 1040, for example) plus the net foreign income exclusion amount.

Net investment income includes interest, dividends, capital gains (including the taxable portion of home and private business sales), taxable annuity payments, royalties, **rents and passive investment income**. The portion of net investment income subject to the Surtax will equal the lesser of (1) total net investment income or (2) the amount by which net investment income exceeds MAGI over the threshold amount.

Passive Activity Losses

During the 1980's, Congress enacted rules to curb the use of tax shelters that had become so prevalent then. These "passive activity loss" rules prevented taxpayers from investing passively in real estate activities to create losses that could offset their active income.

Previously, these rules seemed more relevant to investors hoping to generate losses to offset income. These rules have triggered a new side effect in light of the Surtax. That is, they operate to classify rental income earned by some landlords as passive investment income that may be subject to the Surtax.

There remains an exception to the passive activity loss rules, though, because they do not apply to "real estate professionals". In other words, real estate professionals can earn rental income in their ordinary course of business that will not be subject to the Surtax (since it's treated as active and not passive investment income).

Real Estate Professionals

Taxpayers cannot simply own and manage real estate and qualify as real estate professionals. Instead, they must meet three requirements (one of which involves passing one of seven threshold tests).

The full details of these requirements and tests are beyond the scope of this article. However, they generally involve:

The Material Participation Requirement

A taxpayer must meet one of seven tests that are all based on the number of hours the taxpayer dedicates to managing real estate activities as compared to other activities. In general, a taxpayer must dedicate more than 500 hours toward the business or more than 100 hours in the business if that represents more time than anyone else spends toward it. This serves as the threshold test.

Personal Service Requirement

The taxpayer then must show dedication of more than 750 hours personally toward real estate activities in which the taxpayer materially participates.

The Majority Service Requirement

Finally, the taxpayer must dedicate more time toward these real estate activities as compared to any other job the taxpayer maintains. In other words, taxpayers with full-time jobs will have trouble spending more time managing real estate than they spend at their job.

Again, taxpayers who qualify as real estate professionals can earn rental income that is not subject to the Surtax. On the other hand, taxpayers who cannot qualify as real estate professionals will earn rental income that will be (treated as passive investment income) subject to the Surtax.

Taxpayers may be able to group their activities when trying to qualify as real estate professionals.

The distinction between landlords and real estate professionals remains important in light of the Surtax. That is, landlords may pay the Surtax. Real estate professional do not pay the Surtax . . . at least with respect to their business related rental income.

▸ Taxpayers may be able to group their activities when trying to qualify as real estate professionals.

Sources: Patient Protection and Affordable Care Act of 2010 (Public Law 111-148); Internal Revenue Code Section 469 and its related Regulations; IRS Publication 925

Opinions referenced are as of March 1, 2013 and are subject to change due to changes in the market, economic conditions or changes in the legal and/or regulatory environment and may not necessarily come to pass. This discussion is intended to be informational only and is not exhaustive or conclusive. While Calamos Wealth Management has used reasonable efforts to obtain information from reliable sources, we make no representations or warranties as to the accuracy, reliability or completeness of third party information presented herein. Calamos and its representatives do not provide tax or legal advice. Each individual's tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation. This information is provided for informational purposes only and should not be considered tax or legal advice.

For more information about federal and state taxes, please consult the Internal Revenue Service and the appropriate state-level departments of revenue, respectively.

CWM and its representatives do not provide accounting, tax or legal advice. Each individual's tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation. This information is provided for informational purposes only and should not be considered tax or legal advice. Please refer to important disclosures on last page.

Calamos Wealth Management LLC is a federally registered investment advisor. Form ADV Part 2A, which provides background information about the firm and its business practices, is available upon written request to:

Calamos Wealth Management LLC

2020 Calamos Court
Naperville, IL 60563-2787

Attn: Compliance Officer

©2013 Calamos Investments LLC. All Rights Reserved.

CALAMOS®

Calamos Wealth Management LLC
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | www.calamos.com/wm | caminfo@calamos.com

© 2013 Calamos Investments LLC. All Rights Reserved.
Calamos® and Calamos Investments® are registered trademarks of Calamos Investments LLC.