May 2022

How Rental Property Owners Can Avoid the Net Investment Income Tax

The federal income tax tables do not give you your "true" tax rates.

Here's one example: the net investment income tax (NIIT). It's a hefty 3.8 percent on top of what you pay according to the table rates.

If you own rental property, you're one of the NIIT's prime targets.

But in this article, we'll show you three ways you can remove yourself from the NIIT bull's-eye.

Who Is Subject to the NIIT?

You pay the NIIT only if[1]

- your modified adjusted gross income (MAGI) exceeds $200,000 if you're single, or $250,000 if you're married filing jointly ($125,000 for married couples filing separately), and
- you have net investment income.

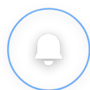
Your MAGI for NIIT purposes is likely the same as your adjusted gross income (AGI), which equals your gross income less any above-the-line deductions. The tax code modifies the NIIT AGI only for certain U.S. citizens or residents who live abroad.

Net investment income consists of[2]

- net rental income;
- income from investments, including interest, dividends, and annuities;
- income from any business in which you don't materially participate, including real estate limited partnerships and other real estate investment businesses; and
- net capital gains earned on the sale of property that is not part of an active business, including rental property, stocks and bonds, and mutual funds.

Net investment income does not include[3]

- income from a business in which you materially participate (including income from the sale of property held in such a business);
- self-employment income subject to self-employment tax;
- wages from employment;
- tax-exempt income, such as income from tax-exempt bonds;



- distributions from qualified retirement plans, such as traditional or Roth IRAs, 401(k)s, or payouts from traditional defined-benefit pension plans; or
- life insurance proceeds, veterans' benefits, Social Security benefits, alimony, or unemployment benefits.

If you own real estate rentals through a pass-through entity, such as a limited liability company, a partnership, or an S corporation, the NIIT rules apply to you at the individual level. Your share of the profits from the entity will pass through to your individual tax return and must be included with your other net investment income for purposes of the NIIT.

If you sell your rental property for a gain, you include the gain in your net investment income for that year. The gain inclusion can subject you to the NIIT, even if your AGI is ordinarily less than the threshold.

For example, if you have owned a rental property for many years and earn a $1 million profit when you sell, you'll pay a $38,000 NIIT.

How to Calculate the NIIT

You must pay the 3.8 percent NIIT on the *lesser* of[4]

- your net investment income, or
- the amount your MAGI exceeds the applicable $200,000/$250,000 threshold.

Example. Bill, a single taxpayer, earns $300,000 in wages and $100,000 in net investment income from real estate rentals during the year. His MAGI is $400,000.

Bill must pay the 3.8 percent NIIT on the lesser of

- his $100,000 of net investment income, or
- the amount his $400,000 MAGI exceeds the $200,000 threshold for single taxpayers—$200,000.

Since $100,000 is less than $200,000, he must pay the 3.8 percent tax on $100,000. His NIIT for the year is $3,800 (3.8 percent x $100,000 = $3,800).

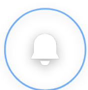
If your MAGI is not much over the threshold amount, your NIIT will be quite small no matter how much net investment income you have. For example, if you're married and your MAGI is $260,000, your NIIT can be no more than $380 (3.8 percent x $10,000).

You report the NIIT on IRS Form 8960, *Net Investment Income Tax—Individuals, Estates, and Trusts*.[5]

But you won't pay any NIIT on your rental property income or file Form 8960 if you qualify for one of the three following exemptions from the NIIT.

NIIT Exemption #1: Real Estate Professionals

Don't let the term "real estate professional" scare you away. For the NIIT, the tax code defines the real estate professional. You may qualify.



When it comes to rental property, tax-law-defined real estate professionals earn supreme status because they

- deduct their losses from non-rental income, and
- most likely qualify to have their profits escape the NIIT.

Thus, if you can achieve tax-law-defined real estate professional status, you have the best of all tax worlds: deductible losses *and* (most likely) profits that escape the NIIT.

You may have noted "most likely" in the sentence above. You overcome the "most likely" on the NIIT when your rental activity qualifies as a business for tax purposes.

Real Estate Professional Status

To qualify as a real estate professional, either you or your spouse (if you file jointly) must spend (1) over 50 percent of your work time in a real estate business or businesses and (2) over 750 hours working in real estate businesses during the year.[6] As a rule, people with full-time jobs outside of real estate find it difficult to qualify. For detailed guidance, see Audit-Proof Your Time Spent on Rental Properties.

Material Participation in Rental Activity

In addition to being a real estate professional, you must materially participate in your rental activity to deduct your losses or qualify for the NIIT exemption. There are seven ways to establish material participation. The two most common are[7]

- doing all the work on the rental, or
- working more than 100 hours on the rental and that's more than any other individual works on the rental.

If you have more than one rental property, you can group them together for purposes of establishing material participation, by filing an election with your return. This way, you can combine the time you spend working on each rental property to satisfy the material participation test.[8]

For a great explanation of how this works, see Know Why the Court Denied Losses on Four of Six House Rentals.

Rental Activity as a Business

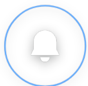
There is one more hoop you must jump through for the NIIT exemption: Your rental activity must qualify as a business, not a mere investment activity, under IRC Section 162. Most rental activities are businesses even though they're reported on Schedule E, but the legal tax definition is somewhat nebulous.[9]

For purposes of the NIIT only, IRS regulations establish a safe-harbor rule for when a rental estate activity conducted by a real estate professional is a business: so long as the real estate professional devotes more than 500 hours per year to the rental activity, it automatically qualifies as a business for NIIT purposes.

Alternatively, if a real estate pro has participated in rental real estate activities for more than 500 hours per year in five of the past 10 tax years, the rental activity will qualify as a business.[10] As with material participation, if you have more than one rental property, you may group your rental activities together for these purposes.

It's questionable whether the 500-hour rule is really needed. And the regulations make clear that the rule is a safe harbor, not a minimum requirement.[11]

Thus, you don't have to work a minimum of 501 hours per year at your rental activity for it to qualify as a business. You can work fewer hours and still qualify as a business.



Indeed, it's highly likely that if you materially participate in your rental activity, it is a business. For more on this, see Are Your Rental Properties a Business? If So, You Win.

NIIT Exemption #2: Short-Term Rentals

The short-term rental is exempt from the tax-law-defined real estate professional rules. To deduct your losses on a short-term rental, you need to materially participate in the property.

As to whether you report your short-term rental losses (or profits) on Schedule C or E of your tax return, see Vacation Home Rental—What's Best for You: Schedule C or E?

Schedule C short-term rentals are businesses and exempt from the NIIT, providing you materially participate in the rentals.[12]

Schedule E short-term rentals could rise to the level of a business, just as a long-term rental can. See Are Your Rental Properties a Business? If So, You Win. If they make the business category, they are exempt from the NIIT.

NIIT Exemption #3: Self-Rentals

Passive income from rental property that would otherwise be subject to the NIIT is recharacterized as non-passive if you rent the property to a business in which you materially participate. In other words, income from self-rentals is not included in net investment income.[13]

Example. Albert, an accountant, owns all the stock of ABC, Inc., an S corporation, and is employed full-time by the corporation. He personally owns an office building that he rents to the corporation. He earns $20,000 in profit from the rental. This income is not subject to the NIIT.

Planning note. For the NIIT, you can group the self-rental with the C corporation. But you may not group the self-rental with a C corporation for purposes of the passive loss rules.

When you (or your spouse, or you and your spouse) wholly own a rental property that you rent to your wholly owned business other than a C corporation, you may elect to group the rental activity and business (in which you materially participate) into one activity for purposes of the passive loss rules.[14] Here, you treat the rental income as derived from a non-rental business, and it is not subject to the NIIT.

Key point. The advantages of such grouping are that you don't have to worry about either the passive loss rules or the NIIT, and that you can deduct losses from the rental property. See Avoid the Self-Rental Trap for more on self-rental grouping, and remember that this passive loss grouping is not available with a C corporation.

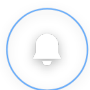
Takeaways

Here are six takeaways from this article:

1. The often-overlooked NIIT is a 3.8 percent tax on taxpayers with an AGI over $200,000 if single, or $250,000 if married filing jointly. The tax is paid on the lesser of net investment income or the amount AGI exceeds the threshold.

2. Net investment income includes income from real estate rentals, but not from rental businesses in which you materially participate.

3. Tax-law-defined real estate professionals are exempt from the NIIT so long as their rental activity qualifies as a business activity.



4. Short-term rentals **reported on Schedule C** of your Form 1040 trigger the self-employment tax but are exempt from the NIIT if you materially participate in the rentals.

5. Short-term rentals **reported on Schedule E** can qualify as businesses, and if so, they escape the NIIT if you materially participate.

6. Self-rentals of your rental property to a business you own and in which you materially participate are exempt from the NIIT.

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1 IRC Section 1411(a)(1).
2 IRC Section 1411(c).
3 Reg. Section 1.1411-1(d)(4).
4 IRC Section 1411(b).
5 IRS Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts (2021).
6 IRC Section 469(c)(7)(B); 469(c)(7)(C).
7 Reg. Section 1.469-5T(a).
8 Reg. Section 1.469-11(b)(3)(iv).
9 See Are Your Rental Properties a Business? If So, You Win.
10 Reg. Section 1.1411-4(g)(7).
11 Reg. Section 1.1411-4(g)(7)(iii).
12 Reg. Section 1.1411-4(b).
13 Reg. Section 1.469-2(f)(6).
14 Reg. Section 1.469-4(d)(1).