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Tax Planning Opportunities for Data Center Land Assembly — Net Investment Income Tax Exemption for Active Participants in Land Assemblage Activities

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The Growing Demand for Data Center Land

The explosive growth of artificial intelligence (AI), cloud computing and digital infrastructure has created unprecedented demand for data center development. Developers and investors are increasingly focused on assembling land parcels in strategic locations to accommodate large-scale data center projects.

This advisory examines a significant tax planning opportunity available to taxpayers engaged in data center land assembly — specifically, the potential to claim an exemption from the 3.8 percent Net Investment Income Tax (NIIT) under Section 1411 of the Internal Revenue Code. The principles discussed herein apply to land assembly activities generally but are especially relevant to participants in the data center sector, where substantial profits may be realized from the acquisition, assemblage and disposition of land parcels.

Overview of the Net Investment Income Tax

Section 1411 imposes a 3.8 percent tax on the "net investment income" of individuals, estates and certain trusts whose modified adjusted gross income exceeds applicable thresholds ($200,000 for single filers and $250,000 for married couples filing jointly). Net investment income generally includes interest, dividends, capital gains, rental income, royalties and income from passive activities. For taxpayers engaged in significant real estate transactions, the NIIT can represent a meaningful additional tax burden on profits from land sales and development activities.

However, Congress carved out an important exception for income derived from a trade or business in which the taxpayer materially participates. Understanding and satisfying the requirements of this exception can yield substantial tax savings for data center developers and land assemblers.

The Passive Activity Rules Under Section 469

Under Section 469(c)(1), a "passive activity" is any activity that (1) involves the conduct of a trade or business, and (2) in which the taxpayer does not materially participate. Both elements must be present for an activity to be classified as passive.

For taxpayers who assemble land parcels as part of an active trade or business, the critical question is whether they “materially participate” in that business. Treasury Regulation Section 1.469-5T sets forth seven tests for material participation, any one of which is sufficient. The most commonly relied-upon tests include participation for more than 500 hours during the taxable year; participation that constitutes substantially all of the participation in the activity; and participation for more than 100 hours if no other individual participates more.

Importantly, this exemption is not available for real estate ventures in which the taxpayer builds and rents real property — such activities are passive by definition and thus subject to the NIIT.

Exemption from the Net Investment Income Tax

Section 1411(c) defines net investment income to include gross income from passive activities and net gain from the disposition of property, but expressly excludes income and gains derived from a trade or business in which the taxpayer materially participates. Specifically, Section 1411(c)(1) provides that net investment income does not include income or gain from a non-passive trade or business (other than a business of trading in financial instruments or commodities).

In summary: interest, dividends, capital gains, rental income, and royalties are subject to the NIIT; income from a passive trade or business is also subject to the NIIT; but income from a non-passive trade or business is exempt.

Accordingly, where a taxpayer assembles land parcels as part of a trade or business and materially participates in that business, profits from the land assembly activity — whether characterized as ordinary income or capital gain — are excluded from net investment income and not subject to the 3.8 percent NIIT. This exemption applies regardless of whether the taxpayer (1) assembles parcels for its own data center development, or (2) assembles parcels for sale to unrelated third parties who will construct data centers on the assembled land.

Application to Data Center Land Assembly

Data center developers and investors may structure their land assembly activities to take advantage of the NIIT exemption. Several planning considerations are relevant.

Establishing a Trade or Business

The taxpayer must be engaged in a trade or business of assembling land parcels rather than merely holding land as a passive investment. Factors indicating trade or business status include the frequency and continuity of land acquisition activities, the extent of efforts to identify and negotiate parcel purchases, engagement with brokers and consultants, active management of the assembly process, and the taxpayer's intent to profit from the assembled parcels through sale or development.

Material Participation

The taxpayer (or, in the case of a pass-through entity, the relevant owners) must materially participate in the land assembly business. This typically requires demonstrating sufficient hours of participation under one of the regulatory tests. Careful documentation of time spent on land assembly activities, including due diligence, negotiations, zoning efforts, infrastructure planning, and coordination with potential buyers or developers, is essential. We recommend that the taxpayer serve as the manager or managing member of the entity that assembles the parcels, thereby distinguishing themselves from passive investors.

Dealer Versus Investor Status

Taxpayers who assemble land parcels primarily for sale to customers in the ordinary course of business are treated as "dealers" and will recognize ordinary income on the sale of assembled parcels. Taxpayers who assemble parcels for their own development, or who hold parcels for appreciation before sale, may be treated as investors and may recognize capital gain on disposition. In either case, if the activity constitutes a trade or business and the taxpayer materially participates, the profits are excluded from net investment income.

Considerations for Rental Income During the Holding Period

Taxpayers should be aware that if assembled parcels generate rental income during the holding period — for example, through interim leases to agricultural users or for temporary storage — such rental income may be treated as per se passive under Section 469(c)(2), regardless of material participation. Per se passive rental income would be subject to the NIIT unless the taxpayer qualifies as a "real estate professional" under Section 469(c)(7), which requires more than 750 hours of services in real property trades or businesses and that more than half of the taxpayer's personal services are performed in such trades or businesses.

Taxpayers engaged in data center land assembly should consider structuring interim uses of assembled parcels to minimize rental characterization or should evaluate whether they qualify for the real estate professional exception.

Planning Recommendations

Taxpayers involved in data center land assembly should consider the following steps to maximize the potential for NIIT exemption:

1. **Structure as a bona fide trade or business.** The land assembly activity should involve regular and continuous acquisition, management and disposition activities sufficient to establish trade or business status.
2. **Document material participation.** Taxpayers (or the relevant owners of pass-through entities) should ensure they meet one of the material participation tests and maintain contemporaneous records documenting hours of participation and the nature of activities performed.
3. **Manage interim income characterization.** Carefully analyze the character of any income generated during the holding period and minimize rental income that could be treated as per se passive.
4. **Evaluate entity structure.** Consult with tax advisors regarding entity structuring, including the use of S corporations or partnerships that can facilitate material participation by individual owners.

Conclusion

The significant profits that can be realized from data center land assembly may be exempt from the 3.8 percent NIIT where the taxpayer conducts the assembly as part of an active trade or business and materially participates in that business. Proper planning and documentation are essential to securing this favorable tax treatment.

We encourage clients and prospective clients engaged in data center development or land assembly to contact us to discuss how these principles may apply to their specific circumstances.

CONTACTS

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