Net Investment Income Tax

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A. Introduction

1. Created as part of the Health Care and Education Reconciliation Act in 2010, a 3.8% "Net Investment Income Tax" (NIIT) is imposed on individuals, estates, and trusts [Sec. 1411].

2. The 3.8% Net Investment Income Tax rate is computed by taking the 1.45% FICA tax imposed on both the employer and the employee and adding the 0.9% Additional Medicare Tax.

3. Only U.S. citizens and resident aliens with net investment income that exceeds the Modified Adjusted Gross Income (MAGI) thresholds in the table below need to pay the NIIT, though. On the other hand, non-resident aliens are not subject to this tax. The only exception is if they elect to be treated as a resident so they can file jointly with their U.S. citizen or resident spouse.

4. If you're a U.S. citizen or resident married to an Non-Resident Alien (NRA), your filing status will be married filing separately for purposes of determining your MAGI, net investment income, and whether you're subject to the NIIT.

B. For individuals, the tax is imposed on the lesser of:

1. An individual's "net investment income" (also known as unearned income) for the tax year, or

2. Any excess of "modified adjusted gross income" (MAGI) for the tax year over a threshold amount [Sec.1411(a)(1)].

    a. The "threshold amount is $200,000 for single taxpayers and heads-of-households; $250,000 for married filing jointly and surviving spouses; $125,000 for married filing separately [Sec. 1411(b)].

        1) The threshold amounts are not indexed for inflation.

        2) Only 3 to 5% of individuals have AGI above the thresholds.

C. Estates and Trusts

1. Estates and trusts may also need to pay the NIIT. In the case of an estate or trust, the NIIT is 3.8 percent. This pertains to estates and trusts that have both undistributed net investment income and adjusted gross income past the dollar amount at which the highest estate/trust tax bracket begins for the current tax year. For 2024, this amount is $15,200, which is up from $14,450 in 2023.

2. The IRS stipulates that there are a few types of trusts not subject to the NIIT, including:

    - Trusts that are exempt from income taxes
    - Grantor trusts
    - Perpetual care trusts
    - Trusts that are not classified as “trusts” for federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).
    - Electing Alaska Native Settlement Trusts
    - Perpetual Care (Cemetery) Trusts.

3. There are special computational rules for certain unique types of trusts, such as Qualified Funeral Trusts, Charitable Remainder Trusts and Electing Small Business Trusts.

D. "Gross investment income" is defined as: [Sec. 1411(c)(1) and (c)(2)]

1. Gross income from interest, dividends, annuities, royalties, and rents (unless such rental income is "derived in the ordinary course of any trade or business;"

    a. Substitute interest and dividends are included in the calculation of net investment income.

2. Other gross income from any passive trade or business;

    a. A passive activity for purposes of net investment income has the same meaning as under section 469. A passive activity includes any trade or business in which you don’t materially participate. A passive activity also includes any rental activity, regardless of whether you materially participate.

    b. If you’re a real estate professional for purposes of section 469(c)(7), your rental income or loss won’t be passive if you materially participated in the rental real estate activity with certain restrictions.

c. However, your rental income is included in net investment income if the income isn't derived in the ordinary course of a trade or business. Qualifying as a real estate professional doesn't necessarily mean you're engaged in a trade or business with respect to the rental real estate activities. If your rental real estate activity isn't a section 162 trade or business or you don't materially participate in the rental real estate activities, the rental income will be included in NIIT.

d. If you qualify in the year you dispose of the property used in the rental real estate activity, the amount of gain or loss from the disposition is also deemed to be derived from property used in the ordinary course of a trade or business and isn't included in your net investment income.

e. Net gain is included in computing taxable income that is attributable to the disposition of property other than property held in any trade or business that is not a "passive trade or business."

3. In general, an interest in a partnership or S corporation isn't property held for use in a trade or business and, therefore, gain or loss from the sale of a partnership interest or S corporation stock is included in your net investment income.

4. The amounts of Net Investment Income that are included on your Form 1040 by reason of Form 8814 (including child's income on your return) are included in calculating your Net Investment Income. However, the calculation of your Net Investment Income does not include (a) amounts excluded from your Form 1040 due to the threshold amounts on Form 8814 and (b) amounts attributable to Alaska Permanent Fund Dividends.

5. In Chief Counsel Advice the IRS ruled that dividend income received by an individual shareholder from a C corporation, in which the shareholder was an employee, is subject to the Net Investment Income Tax. The IRS concluded that "being a shareholder in a C corporation in and of itself is not a trade or business" [CCA 202118009].

   a. This conclusion is the same even if the C corporation is a closely-held corporation.

E. For Income to be Excluded from Net Investment Income

- The income must be earned in a "trade or business,"
- The income must be earned in the "ordinary course of a trade or business,"
- The trade or business cannot be the trading of financial instruments or commodities, and
- The individual must not be a passive investor in the business.

F. Exceptions to "Net Investment Income"

1. Net investment income does not include: [Sec. 1411(c)(6)]

   a. Wages

   b. Unemployment compensation

   c. Operating income from a nonpassive business

   d. Alimony

   e. Tax-exempt income such as interest on tax-exempt bonds and veterans' benefits.

   f. Any distribution from qualified employee benefit plan or retirement arrangements;

   g. Any distributions from a regular IRA or Roth IRA;

   h. Social security benefits;

   i. Any item taken into account in determining self-employment income for the tax year on which an individual pays hospital insurance tax under Sec. 1401(b).

   j. The funds used to make contributions to the various types of retirement accounts have already been subject to employment and Medicare taxes.

k. The excluded gain from the sale of a principal residence.

1) However, gain attributable to depreciation adjustments (which cannot be excluded from income under Sec. 121(d)(6)) is included in net investment income.

2) Gains from sales of second homes are subject to the tax.

2. Retirement Accounts

a. The funds used to make contributions to the various types of retirement accounts have already been subject to employment and Medicare taxes.

3. Sale of Residence Examples

a. Example 1: A, a single filer, earns $210,000 in wages and sells his principal residence that he has owned and resided in for the last 10 years for $420,000. A's cost basis in the home is $200,000. A's realized gain on the sale is $220,000. Under section 121, A may exclude up to $250,000 of gain on the sale. Because this gain is excluded for regular income tax purposes, it is also excluded for purposes of determining Net Investment Income. In this example, the Net Investment Income Tax does not apply to the gain from the sale of A's home.

b. Example 2: B and C, a married couple filing jointly, sell their principal residence that they have owned and resided in for the last 10 years for $1.3 million. B and C's cost basis in the home is $700,000. B and C's realized gain on the sale is $600,000. The recognized gain subject to regular income taxes is $100,000 ($600,000 realized gain less the $500,000 section 121 exclusion). B and C have $125,000 of other Net Investment Income, which brings B and C's total Net Investment Income to $225,000. B and C's modified adjusted gross income is $300,000 and exceeds the threshold amount of $250,000 by $50,000. B and C are subject to NIIT on the lesser of $225,000 (B's Net Investment Income) or $50,000 (the amount B and C's modified adjusted gross income exceeds the $250,000 married filing jointly threshold). B and C owe Net Investment Income Tax of $1,900 ($50,000 X 3.8%).

c. Example 3: D, a single filer, earns $45,000 in wages and sells her principal residence that she has owned and resided in for the last 10 years for $1 million. D's cost basis in the home is $600,000. D's realized gain on the sale is $400,000. The recognized gain subject to regular income taxes is $150,000 ($400,000 realized gain less the $250,000 section 121 exclusion), which is also Net Investment Income. D's modified adjusted gross income is $195,000. Since D's modified adjusted gross income is below the threshold amount of $200,000, D does not owe any Net Investment Income Tax.

G. Net Investment Income

1. In order to arrive at Net Investment Income, Gross Investment Income is reduced by deductions that are properly allocable to items of Gross Investment Income.

2. For purposes of the Net Investment Income Tax, the definition allows the reduction for any otherwise allowable deductions "properly allocable to such income or gain."

    a. Deductions under Sec. 62 related to gross income
    b. Itemized deductions under Sec. 63
    c. Loss deductions under Sec. 165

3. Some common deductions, a portion of which may be properly allocable to Gross Investment Income, include early withdrawal fees, brokerage fees, investment advisory fees, tax preparation charges, local and state income taxes, investment interest expense, expenses related to rental and royalty income, and fiduciary expenses (in the case of an estate or trust).

4. A large capital loss in excess of any capital gain for a particular tax year can only offset up to $3,000 of other "net investment income." Investment interest expense can only be used to offset "net investment income" to the extent otherwise allowed on Form 4952. Any state or local tax attributable to the sources of net investment income may be deducted in computing net investment income.

H. Modified Adjusted Gross Income

1. You can compute your MAGI by taking your adjusted gross income (AGI) and adding back in a few deductions, like IRA contributions, passive loss or income, taxable Social Security payments, student loan interest and more. You can find your AGI on Form 1040, Line 8b. If your MAGI is higher than the statutory threshold for your filing status, then you must pay the net investment income tax.

2. Pension income, social security benefits, and IRA distributions are factored into one's AGI which in turn, impacts the determination of whether the applicable $200,000/$250,000 MAGI threshold has been exceeded.

I. How to File the NIIT

1. Attach Form 8960 to your return if your modified adjusted gross income (MAGI) is greater than the applicable threshold amount and you have net investment income.

2. IRS Form 8960 is devoted to the calculation of the net investment income tax. When you're ready to report and pay your NIIT, you'll do so via Form 1040. Estates and trusts looking to file the NIIT should use Form 1041.

J. Net Investment Income Tax and the Additional .9% Medicare Tax

1. You may be subject to both taxes, but not on the same type of income.

2. The 0.9% Additional Medicare Tax applies to individuals' wages, compensation, and self-employment income over certain thresholds, but it does not apply to income items included in Net Investment Income.

K. Estimated Taxes

1. The Net Investment Income Tax is subject to the estimated tax provisions. Individuals, estates and trusts that expect to be subject to the tax should adjust their income tax withholding or estimated payments to account for the tax increase in order to avoid underpayment penalties.

L. Credits

1. Any federal income tax credit that may be used to offset a tax liability imposed by subtitle A of the Code may be used to offset the NIIT. However, if the tax credit is allowed only against the tax imposed by chapter 1 of the Code (regular income tax), those credits may not reduce the NIIT. For example, foreign income tax credits (sections 27(a) and 901(a)) and the general business credit (section 38) are allowed as credits only against the tax imposed by chapter 1 of the Code, and therefore may not be used to reduce your NIIT liability. If you take foreign income taxes as an income tax deduction (versus a tax credit), some (or all) of the deduction amount may deducted against NII.

M. Strategies to Manage Net Investment Income Tax

1. You can manage your net investment income tax liability using strategies to reduce both the amount of net investment income reported and modified adjusted gross income.

2. Time Your Capital Gains

    a. If you can, pay particular attention to the timing of capital gains recognition. You may be able to time the sale of securities that have seen large gains with the simultaneous sale of those that have seen significant losses. This is a process called tax-loss harvesting that can help you decrease the net income you see. If your income fluctuates significantly year to year, you may also be able to time the sale of your securities to years when your MAGI is below the NIIT threshold.

3. Take Advantage of Charitable Contributions

    a. You may be able to reduce net investment income through charitable contributions. If you're already planning to make charitable donations, see if you can swap your cash payments for a donation of appreciated securities instead. This way, you won't be obligated to report a gain on your tax return and you'll still be able to enjoy the tax deduction that comes from the charitable contribution.

    b. In addition, you might consider a charitable remainder trust (CRT) to reduce NIIT liability. "A CRT is an irrevocable, tax-exempt trust in which the grantor places assets to provide income during a specific period of time. CRTs are exempt from Section 1411 [the section of the tax code that applies to the NIIT], which means that gains sold by the CRT won't be subject to the net investment income tax.

4. Adjust Your MAGI

    a. If you're reliant on fixed income investments, consider municipal bonds instead of other bond types. These instruments are exempt from federal tax and also generally exempt from state income tax if the bonds are issued in the state where the taxpayer resides.

    b. Other investments that can help reduce MAGI include growth stocks, which typically don't pay dividends and won't affect your MAGI until you sell them and realize gains. Instruments like whole life policies that accumulate cash value and tax-deferred annuities don't generate taxable income until withdrawal. Importantly, aim to maximize contributions to tax-advantaged retirement vehicles like 401(k), 403(b), or SEP IRA. Unlike IRA contributions, contributions to these accounts do decrease your MAGI.

5. Increased Investment Expenses

   a. Another strategy is to increase the amount you claim for certain investment expenses, which then lowers net investment income. These can be expenses you deduct for rental property upkeep or maintenance, trading fees and even state taxes. Property taxes on investment properties might even pass as a way to offset net investment income, but again it’s important to be careful it’s properly titled and legal.

6. Distributing Trust Income to Beneficiaries

   a. Trustees of trusts where the NIIT applies can reduce or avoid paying the NIIT tax by distributing income to beneficiaries, so long as doing so is in accordance with the trust's terms.

      1) However, when income is distributed from a trust, the beneficiary becomes responsible for the taxes due.

      2) Distributing income may result in an overall tax savings if the beneficiary's MAGI is lower than the NIIT thresholds.

Elmer, a single individual, earns $190,000 in wages and/or net self-employment income and also has $40,000 of "net investment income" for the year. Assuming a $230,000 MAGI, he will have to pay a 3.8% Net Investment Income Tax on the lesser of his (1) $40,000 of net investment income, or (2) $30,000 ($230,000 MAGI - $200,000 threshold). Elmer will pay a $1,140 ($30,000 × 3.8%) Net Investment Income Tax for the year.

During the year, an unmarried taxpayer received no wages or self-employment income, but lives strictly off of her $1 million in "net investment income" from a stock and bond portfolio. Assuming a $1 million MAGI, she will have to pay a 3.8% Net Investment Income Tax on the lesser of her (1) $1 million net investment income or (2) $800,000 ($1 million - $200,000 threshold). As a result, she will pay a $30,400 ($800,000 x 3.8%) Net Investment Income Tax for the year.

John is an owner of a business that rents equipment and machinery. He also materially participates in that business. Regardless of the business being operated as an S corporation, LLC/partnership, or a sole proprietor ship, any net income or loss therefrom would not be considered for purposes of the 3.8% Net Investment Income Tax calculation. However, a Schedule C sole proprietor or the K-1 recipient of "Box 1—Trades or Business Income” from an LLC/partnership would still have the potential for the 0.9% Medicare tax on earned income.

John is a "real estate professional" for purposes of the passive loss rules. He also "materially participates" in the rental activities that he owns. The Net Investment Income Tax would not apply to the rental activities if his "rental activities" are treated as "trades or business" under Sec. 162. The income would not be subject to any self-employment tax under Sec. 1402. However, assume the rental activities are not “trades or business" for Sec. 162. As a result, any net rental income or loss would be part of his 3.8% Net Investment Income Tax calculation.