What's the Net Investment Income Tax and How does It Apply to Me?

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The Net Investment Income Tax (NIIT) effects most taxpayers; however, it has a more substantial impact on business owners and investors. Under the Internal Revenue Code (IRC) Section 1411, the NIIT was created and placed into effect on January 1, 2013. The NIIT is applied at a rate of 3.8% to certain net investment income of an individual and for trusts and estates that have income above the statutory thresholds. These thresholds, unlike most, are NOT annually adjusted for inflation.

Having Been put into effect in 2013, the NIIT affects income tax returns of individuals, estates and trusts, beginning with their first tax year on (or after) Jan. 1, 2013.

The statutory thresholds are set at the following amounts based on the filing status of the taxpayer(s).

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

You may be wondering, “What is included in ‘Investment Income’?” In general, investment income includes, but is not limited to:

- Interest,
- Dividends,
- Capital gains,
    - Gains from the sale of stocks, bonds, and mutual funds.
    - Capital gain distributions from mutual funds.
    - Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence).
    - Gains from the sale of interests in partnerships and S corporations (to the extent the partner or shareholder was a passive owner).
- Rental and royalty income,
- Non-qualified annuities,

- Income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer (within the meaning of US Code section 469[1]).

It is also important to understand which types of income are not considered or included in Net Investment Income. This knowledge can help taxpayers to avoid or reduce their NIIT liability. Below is a non-exhaustive list of common types of income that will not be considered Net Investment Income:

- Wages,
- Unemployment compensation;
- Operating income from a nonpassive business,
- Social Security Benefits,
- Alimony,
- Tax-exempt interest,
- Self-employment income,
- Alaska Permanent Fund Dividends (see Rev. Rul. 90-56, 1990-2 CB 102) and
- Distributions from certain Qualified Plans (those described in sections 401(a), 403(a), 403(b), 408, 408A or 457(b)).

Now, let's discuss some taxpayers and estate planning structures that are NOT subject to the NIIT. The tools of financial planning may be used to avoid the extra 3.8% tax on investment income. The IRS has listed on their website the following exemptions from NIIT:

- Trusts that are exempt from income taxes
- Grantor trusts
- Trusts not technically classified as "trusts" for federal income tax purposes
- Perpetual care trusts
- Electing Alaska Native Settlement Trusts

An investor must pay the NIIT based on the lesser of your net investment income or the amount by which your modified adjusted gross income (MAGI) surpasses the filing status-based thresholds imposed by the IRS. What this basically states, the 3.8% tax will apply in two situations:

- An investor's net investment income is less than the amount which the investors MAGI exceeds the statutory threshold, the tax applies to your NII.
- An investor's net investment income is higher than the amount by which the NII and MAGI exceeded the statutory threshold, the tax applies to that exceeding value.

In order to report and calculate the NIIT, individuals, trusts, and estates use Form 8960. To pay the tax, taxpayer will fill out Form 1040 (if an individual) or Form 1041 (if a trust or

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[1] The term "passive activity" shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest. (B) Income in subsequent years. 26 US Code section 469.

estate.) Further, taxpayers that deal with estimated tax payments must still consider the NIIT in order to avoid certain penalties associated with under estimating or underreporting tax liability. While this tax must be considered in estimated tax payment, the tax does not need to be withheld from an employee's wages.

Let's look at an example with actual dollar amounts. The filing status of our hypothetical investor, Tina Taxpayer, is single. Therefore, the statutory threshold is $200,000. If Tina Taxpayer has a MAGI of $120,000 and net investment income of $40,000, equaling a total of $160,000, she will not be subject to the NIIT because the amount is lower than the Statutory threshold of $200,000. Now, under the same conditions, let's change the values. Tina Taxpayer has a MAGI of $170,000 and net investment income of $80,000, equaling $250,000. Because that amount is $50,000 over the $200,000 statutory threshold, she will pay the 3.8% tax on the $50,000 at $1,900.

If you have questions about the Net Investment Income Tax or your thinking of selling your business, please feel free to reach out to the tax planning professionals at The Center for Financial, Legal and Tax Planning. We're able to assess any exposure to the Net Investment Income Tax, whether in a transactional, restructuring, or general investment scenario. Please call or email at (618) 997-3436 or rbasi@taxplanning.com.