Planning to Avoid or Minimize the 3.8% Net Investment Income Tax

The net investment income tax, or NIIT, is a 3.8% surtax on investment income collected from higher-income individuals. It first took effect in 2013. After filing your 2014 return, you may have been hit with this extra tax for two years, and you may now be ready to get proactive by taking some steps to stop, or at least slow, the bleeding for this year and beyond.

NIIT Basics. The NIIT can affect higher-income individuals who have investment income. While the NIIT mainly hits folks who consistently have high income, it can also strike anyone who has a big one-time shot of income or gain this year or any other year. For example, if you sell some company stock for a big gain, get a big bonus, or even sell a home for a big profit, you could be a victim. The types of income and gain (net of related deductions) included in the definition of net investment income and, therefore, exposed to the NIIT, include—

- Gains from selling investment assets (such as gains from stocks and securities held in taxable brokerage firm accounts) and capital gain distributions from mutual funds.
- Real estate gains, including the taxable portion of a big gain from selling your principal residence or a taxable gain from selling a vacation home or rental property.
- Dividends, taxable interest, and the taxable portion of annuity payments.
- Income and gains from passive business activities (meaning activities in which you don’t spend a significant amount of time) and gains from selling passive partnership interests and S corporation stock (meaning you don’t spend much time in the partnership or S corporation business activity).
- Rents and royalties.

Are You Exposed? Thankfully, you are only exposed to the NIIT if your Modified Adjusted Gross Income (MAGI) exceeds $200,000 if you are unmarried, $250,000 if you are a married joint-filer, or $125,000 if you use married filing separate status. However, these thresholds are not all that high, so many individuals will be exposed. The amount that is actually hit with the NIIT is the lesser of: (1) net investment income or (2) the amount by which your MAGI exceeds the applicable threshold. MAGI is your “regular” Adjusted Gross Income (AGI) shown on the last line on page 1 of your Form 1040 plus certain excluded foreign-source income net of certain deductions and exclusions (most people are not affected by this add-back).

Planning Considerations. As we just explained, the NIIT hits the lesser of: (1) net investment income or (2) the amount by which MAGI exceeds the applicable threshold. Therefore, planning strategies must be aimed at the proper target to have the desired effect of avoiding or minimizing your exposure to the tax.

- If your net investment income amount is less than your excess MAGI amount, your exposure to the NIIT mainly depends on your net investment income. You should focus first on strategies that reduce net investment income. Of course, some strategies that reduce net investment income will also reduce MAGI. If so, that cannot possibly hurt.
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Perhaps the most obvious way to reduce exposure to the NIIT is to invest in tax-exempt bonds via direct ownership or a mutual find. There are other ways, too. Contact us to identify strategies that will work in your specific situation.

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