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Understanding the Net Investment Income Tax

A 3.8% net investment income tax applies to some or all of the net investment income of individuals whose modified adjusted gross income (MAGI) exceeds certain thresholds.

If your income hits a certain level, you may face an additional wrinkle in calculating your taxes: the net investment income tax (also referred to as the unearned income Medicare contribution tax). This 3.8% Medicare tax applies to some or all of your net investment income if your modified adjusted gross income (MAGI) exceeds certain thresholds. The tax is in addition to any other income tax applicable to such income.

Note: *If the net investment income tax applies, your long-term capital gains and qualified dividends may be subject to a combined federal tax rate of as much as 23.8% (the top long-term capital gains tax rate of 20% + 3.8%). Your other taxable investment income may be subject to a combined federal tax rate of as much as 40.8% (the top regular income tax rate of 37% + 3.8%). Your investment income may also be subject to state income tax.*

In general, the net investment income tax applies to U.S. individual taxpayers (similar rules apply to certain domestic trusts and estates).

Calculation of net investment income tax

The net investment income tax is equal to 3.8% of the lesser of (a) your net investment income or (b) the excess of your MAGI over:

- $200,000 if your filing status is single or head of household
- $250,000 if your filing status is married filing jointly or qualifying widow(er) with dependent child
- $125,000 if your filing status is married filing separately

For purposes of the net investment income tax, MAGI is generally equal to your adjusted gross income (AGI). However, if you are a U.S. citizen or resident living abroad, you must include in MAGI the foreign earned income that is generally excludable from gross income for federal income tax purposes.

Example: *You and your spouse file a joint tax return. Assume your net investment income is $50,000 and your MAGI is $270,000. The amount of your net investment income subject to this tax is equal to the lesser of (a) $50,000 or (b) the excess of $270,000 over $250,000, or $20,000. Your net investment income tax is equal to $20,000 x 3.8%, or $760.*

Net investment income

Net investment income includes gross income from:

- Interest, dividends, nonqualified annuities, royalties, and rents that are not derived from the ordinary course of a trade or business, and
- Net gain from the disposition of property not used in a trade or business

Gross income and net gain (or loss) from a trade or business may be included in net investment income if the trade or business is (a) a passive activity or (b) engaged in trading financial instruments or commodities.

Note: *In general, a passive activity is a trade or business in which you do not materially participate. Rental activities are treated as passive activities regardless of whether you materially participate, but there are certain exceptions.*

Net investment income is reduced by any income tax deductions allocable to these items of gross income and net gain that are included in net investment income. Examples of deductible items that may be allocated to net investment income include investment interest expense and state and local income tax. Deductions may be subject to limitations.

Note: *Generally, an interest in a partnership or S corporation is not property held for use in a trade or business, and gain or loss from the sale of a partnership interest or S corporation stock is included in net investment income.*

You may be able to reduce exposure to the net investment income tax by controlling the timing of items of income or deduction that enter into the calculation of net investment income or MAGI.

Net investment income does not include income excluded from gross income for income tax purposes. It also does not include items of gross income and net gain specifically excluded from net investment income. Examples of excluded items include:

- Wages
- Unemployment compensation
- Alimony
- Social Security benefits
- Tax-exempt interest income
- Income from certain qualified retirement plan and IRA distributions
- Self-employment income
- Gain that is not taxable on sale of a principal residence

Note: *Even though certain items such as wages and income from certain qualified retirement plan and IRA distributions may not be included in net investment income, they may be included in MAGI, which (as discussed above) is a factor in determining the amount of net investment income that is subject to the net investment income tax.*

Planning for the net investment income tax

For a particular taxable year, the net investment income tax applies only if your MAGI exceeds the appropriate threshold based on your tax filing status. Also, the net investment income tax applies to the lesser of (a) your net investment income or (b) the excess of your MAGI over the appropriate threshold. So you may be able to reduce exposure to the net investment income tax by controlling the timing of items of income or deduction that enter into the calculation of net investment income or MAGI.

For example, you might consider increasing your net investment income in a year in which your MAGI does not exceed the threshold. Conversely, you might consider decreasing your net investment income in a year in which your MAGI exceeds the threshold.

In general, you may be able to increase net investment income in a particular year by pushing income into that year and deductions into another year. Conversely, you may be able to decrease net investment income in a particular year by pushing deductions into that year and income into another year. You will need to consider how increasing or decreasing net investment income affects MAGI.

Example: *Tom, a single taxpayer, is considering selling some stock, either at the end of Year 1 or at the beginning of Year 2, with the effect of increasing his net investment income by $10,000 for one of those years. To keep things simple, assume that an increase in net investment income would result in a dollar-for-dollar increase in MAGI. Before taking into consideration the proposed sale of stock, Tom expects to have $190,000 of MAGI in Year 1 and $200,000 of MAGI in Year 2. If Tom sells the stock in Year 1, he would not be subject to the net investment income tax because his MAGI of $200,000 ($190,000 + $10,000) would not exceed the $200,000 threshold for single taxpayers. If Tom sells the stock in Year 2, he would be subject to the net investment income tax because his MAGI of $210,000 ($200,000 + $10,000) would exceed the $200,000 threshold and he would have $10,000 of net investment income.*

Note: *Ordinary income and long-term capital gains tax rates are generally much higher than the 3.8% Medicare tax rate applicable to net investment income. Planning for the net investment income tax should not be done without considering its effect on the regular income tax.*

Note: *There is no standard deduction for purposes of determining your net investment income. Itemized deductions are not available for purposes of reducing net investment income unless you itemize deductions for purposes of regular income tax. However, neither standard or itemized deductions reduce MAGI.*

Recordkeeping

Net investment income tax is reported on IRS Form 8960. If you owe net investment income tax, you must attach Form 8960 to your tax return. For purposes of the net investment income tax, certain items of investment income or investment expense receive different tax treatment than for the regular income tax. You will need to keep records for the items included on Form 8960. Generally, you need to keep records for the life of the investment to show how you calculated basis. You also need to know what you did in prior years if the investment was part of a carryback or carryforward.

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