The 3.8% Net Investment Income Tax - More Than Meets the Eye

There's a lot for taxpayers to know when it comes to the 3.8% net investment income tax (3.8% NIIT). This new tax is imposed on income from several sources and its impact is far reaching. Analyzing its impact can get complicated fast.

Originating as a component of 2010 health care legislation and first effective in 2013, the 3.8% NIIT is assessed on the lesser of net investment income (NII) or modified adjusted gross income (MAGI) above specific thresholds. MAGI is adjusted gross income plus any excluded net foreign earned income. The MAGI thresholds are $200,000 for single individuals, $250,000 for joint filers and surviving spouses, and $125,000 for married taxpayers filing separate returns.

Only individuals with some amount of NII, and MAGI above the applicable threshold amount, will be subject to the 3.8% NIIT. For example, if a married couple has $200,000 of wage income and $100,000 of interest and dividend income (i.e., MAGI totaling $300,000), the 3.8% NIIT applies to the $50,000 that is over the $250,000 MAGI threshold.

Trusts and estates can also be hit with the 3.8% NIIT. But for them, the tax applies to the lesser of their undistributed net investment income or AGI in excess of the threshold for the top trust federal income tax bracket. For 2013, that threshold is only $11,950, so many trusts and estates will no doubt be affected this year.

The components of NII generally include gross income from interest, dividends, royalties, and rents; gross income from a trade or business involving passive activities; and net gain from the disposition of property (other than property held in a trade or business in which the owner materially participates). All of these components are reduced by any allocable deductions. This may sound simple, but as always, the devil is in the details.

On a positive note, NII does not include tax-exempt bond interest, veterans' and social security benefits, excluded gain from the sale of a principal residence, life insurance proceeds received by reason of an insured's death, lottery winnings, and the tax-free inside buildup of the cash surrender value of life insurance, among other items.

Fortunately, distributions from retirement plans are generally not included in NII. However, if included in MAGI, qualified plan distributions may push the taxpayer over the threshold that would cause other types of investment income to be subject to the 3.8% NIIT.

Another positive aspect of the 3.8% NIIT is that it does not apply to income from a trade or business conducted by a sole proprietor, partnership, or S corporation; but income, gain, or loss on working capital is not treated as derived from a trade or business and thus is subject to the tax. The term working capital generally refers to capital set aside for use in, or the future needs of, a trade or business.

Unfortunately, the 3.8% NIIT does apply to income derived from a trade or business if it is a passive activity or a trade or business of trading in financial instruments or commodities.

With regard to property dispositions, a gain from the disposition of property that is considered held in the ordinary course of a trade or business is generally exempt from the 3.8% NIIT. Despite the preceding exception, gains from dispositions of property held in a passive business activity or in the business of trading in financial instruments or commodities (whether passive or not) are included in the definition of NII.

For business owners, a gain or loss from the disposition of an interest in a partnership or S corporation may be subject to the 3.8% NIIT. However, a complex calculation involving a deemed sale analysis may be required to make this determination.

Finally, a taxpayer may be subject to both the 3.8% NIIT and the additional 0.9% Medicare tax, but not on the same income. The additional 0.9% Medicare tax applies to wages and self-employment income over certain thresholds, but it does not apply to items included in investment income. So, taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes.

Taxpayers face numerous challenges in learning about and dealing with the 3.8% NIIT. Please contact us to discuss the 3.8% NIIT or any other tax compliance or planning issue.

Business Tax Breaks

Several favorable business tax provisions have a limited term life that may dictate taking action between now and year-end. They include the following two provisions.

Section 179 Deduction. Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment, software, and eligible real property costs. For tax years beginning in 2013, the maximum Section 179 deduction is $500,000, including up to $250,000 for qualifying real property costs. However, you cannot claim a Section 179 write-off that would create or increase an overall business tax loss. For tax years beginning in 2014, the maximum deduction is scheduled to drop back to only $25,000, and most real property costs will be ineligible.

50% First-year Bonus Depreciation. Above and beyond the Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, the 50% bonus depreciation break increases the maximum first-year depreciation deduction by $8,000. The 50% bonus depreciation break will expire at year-end unless Congress extends it.