Questions and Answers on the Net Investment Income Tax

Basics of the Net Investment Income Tax

1. What is the Net Investment Income Tax (NIIT)?

The Net Investment Income Tax is imposed by section 1411 of the Internal Revenue Code (IRC). The NIIT applies at a rate of 3.8 percent to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts.

2. When did the Net Investment Income Tax take effect?

The Net Investment Income Tax went into effect on Jan. 1, 2013. The NIIT affects income tax returns of individuals, estates and trusts for their first tax year beginning on (or after) Jan. 1, 2013. It does not affect income tax returns for the 2012 taxable year filed in 2013.

Who Owes the Net Investment Income Tax

3. What individuals are subject to the Net Investment Income Tax?

Individuals will owe the tax if they have Net Investment Income and also have modified adjusted gross income over the following thresholds:

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

Taxpayers should be aware that these threshold amounts are not indexed for inflation.

If you are an individual that is exempt from Medicare taxes, you still may be subject to the Net Investment Income Tax if you have Net Investment Income and also have modified adjusted gross income over the applicable thresholds.

4. What individuals are not subject to the Net Investment Income Tax?

Nonresident Aliens (NRAs) are not subject to the Net Investment Income Tax. If an NRA is married to a U.S. citizen or resident and has made, or is planning to make, an election under IRC section 6013(g) to be treated as a resident alien for purposes of filing as Married Filing Jointly, the proposed regulations provide these couples special rules and a corresponding IRC section 6013(g) election for the NIIT.

5. What Estates and Trusts are subject to the Net Investment Income Tax?

Estates and Trusts will be subject to the Net Investment Income Tax if they have undistributed Net Investment Income and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year (for tax year 2012, this threshold amount is $11,650). There are special computational rules for certain unique types of trusts, such a Charitable Remainder Trusts and Electing Small Business Trusts, which can be found in the proposed regulations (see # 19 below).

6. What Trusts are not subject to the Net Investment Income Tax?

The following trusts are not subject to the Net Investment Income Tax:

1. Trusts that are exempt from income taxes imposed by Subtitle A of the Internal Revenue Code (e.g., charitable trusts and qualified retirement plan trusts exempt from tax under IRC section 501, and Charitable Remainder Trusts exempt from tax under IRC section 664).
2. A trust in which all of the unexpired interests are devoted to one or more of the purposes described in IRC section 170(c)(2)(B).
3. Trusts that are classified as “grantor trusts” under IRC sections 671-679.
4. Trusts that are not classified as “trusts” for federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).

What is Included in Net Investment Income

7. What is included in Net Investment Income?

In general, investment income includes, but is not limited to: interest, dividends, capital gains, 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 IRC section 469). To calculate your Net Investment Income, your investment income is reduced by certain expenses properly allocable to the income (see #12 below).

8. What are some common types of income that are not 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)).

9. What kinds of gains are included in Net Investment Income?

To the extent that gains are not otherwise offset by capital losses, the following gains are common examples of items taken into account in computing Net Investment Income:

1. Gains from the sale of stocks, bonds, and mutual funds.
2. Capital gain distributions from mutual funds.
3. 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 you were a passive owner).

10. Does this tax apply to gain on the sale of a personal residence?

The Net Investment Income Tax will not apply to any amount of gain that is excluded from gross income for regular income tax purposes. The pre-existing statutory exclusion in IRC section 121 exempts the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence from gross income for regular income tax purposes and, thus, from the NIIT.

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 IRC 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.

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 IRC 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%).

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 IRC 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.

11. Does Net Investment Income include interest, dividends and capital gains of my children that I report on my Form 1040 using Form 8814?

The amounts of Net Investment Income that are included on your Form 1040 by reason of Form 8814 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.

12. What investment expenses are deductible in computing NII?

In order to arrive at Net Investment Income, Gross Investment Income (items described in items 7-11 above) is reduced by deductions that are properly allocable to items of Gross Investment Income. Examples of properly allocable deductions include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in Net Investment Income.

13. Will I have to pay both the 3.8% Net Investment Income Tax and the additional .9% Medicare tax?

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

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. See more information on the Additional Medicare Tax.

How the Net Investment Income Tax is Reported and Paid

14. If I am subject to the Net Investment Income Tax, how will I report and pay the tax?

For individuals, the tax will be reported on, and paid with, the Form 1040. For Estates and Trusts, the tax will be reported on, and paid with, the Form 1041.

15. Is the Net Investment Income Tax subject to the estimated tax provisions?

The Net Investment Income Tax is subject to the estimated tax provisions. Individuals, estates, and trusts that expect to be subject to the tax in 2013 or thereafter should adjust their income tax withholding or estimated payments to account for the tax increase in order to avoid underpayment penalties.

16. Does the tax have to be withheld from wages?

No, but you may request that additional income tax be withheld from your wages.

17. What form will I use to report the Net Investment Income Tax?

The IRS has released a draft of Form 8960, which been developed for the purpose of reporting the Net Investment Income Tax. Click here to see a draft of Form 8960 or go to www.irs.gov/draftforms.

Examples of the Calculation of the Net Investment Income Tax

18. How does a Single taxpayer with income less than the statutory threshold calculate the Net Investment Income Tax?

Taxpayer, a single filer, has wages of $180,000 and $15,000 of dividends and capital gains. Taxpayer's modified adjusted gross income is $195,000, which is less than the $200,000 statutory threshold. Taxpayer is not subject to the Net Investment Income Tax.

19. How does a Single taxpayer with income greater than the statutory threshold calculate the Net Investment Income Tax?

Taxpayer, a single filer, has $180,000 of wages. Taxpayer also received $90,000 from a passive partnership interest, which is considered Net Investment Income. Taxpayer's modified adjusted gross income is $270,000.

Taxpayer's modified adjusted gross income exceeds the threshold of $200,000 for single taxpayers by $70,000. Taxpayer's Net Investment Income is $90,000.

The Net Investment Income Tax is based on the lesser of $70,000 (the amount that Taxpayer's modified adjusted gross income exceeds the $200,000 threshold) or $90,000 (Taxpayer's Net Investment Income). Taxpayer owes NIIT of $2,660 ($70,000 x 3.8%).

Additional Information

20. Other than these FAQs, where can I find additional information about the Net Investment Income Tax?

Find it in the full text of the proposed regulations, request for comments, and information on the public hearing.

21. The proposed regulations are effective for tax years beginning after Dec. 31, 2013, but the Net Investment Income Tax went into effect on Jan. 1, 2013. May I rely on the regulations for guidance on the Net Investment Income Tax during 2013?

Taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. To the extent the proposed regulations provide taxpayers with the ability to make an election, taxpayers may make the election provided that the election is made in the manner described in the proposed regulation. Any election made in reliance on the proposed regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. However, if final regulations provide for the same or a similar election, taxpayers who opt not to make an election in reliance on the proposed regulations will not be precluded from making that election pursuant to the final regulations.

Page Last Reviewed or Updated: 08-Aug-2013