

AICPA Personal Financial Planning Section

Robert S. Keebler, CPA, MST: Understanding the Net Investment Income Tax



Statutory Overview

I. OVERVIEW OF NEW TAX EFFECTIVE JANUARY 1, 2013

- A. A new 3.8% NIIT is assessed on the lesser of:
- “Net investment income” OR
 - The excess of “Modified Adjusted Gross Income” (MAGI) over the “threshold amount”
- B. “Net investment income” – is the sum of gross investment income over properly allocable deductions.
- “Investment income” (for purposes of the 3.8% NIIT) includes:
 - Interest
 - Dividends
 - Capital gains
 - Annuities
 - Rents
 - Royalties
 - Passive activity income
 - “Investment income” does not include:
 - Active trade and/or business income
 - Any of the above sources of income in “B1” above (e.g. interest, dividends, capital gains, etc.) to the extent it is derived in an active trade and/or business
 - Distributions from IRAs or other qualified retirement plans
 - Any income taken into account for self-employment tax purposes
- C. “Modified Adjusted Gross Income” (MAGI) – is the sum of adjusted gross income (i.e. Form 1040, Line 37) plus the net foreign income exclusion amount.
- D. “Threshold amount”
- Married taxpayers filing jointly – \$250,000
 - Married taxpayers filing separately – \$125,000
 - All other individual taxpayers – \$200,000
 - Trusts and estates - \$12,150

II. WHO DOES THE NEW TAX AFFECT?

- A. $MAGI \leq \text{“threshold amount”}$ = No application of 3.8% NIIT
- B. Excess of $MAGI > \text{“threshold amount”}$ = Application of 3.8% NIIT to lesser of net investment income or excess over MAGI

Married Filing Jointly Table

Taxable Income	2014	2014 With NIIT ¹
\$ 0 – 18,150	10%	10%
\$ 18,150 – 73,800	15%	15%
\$ 73,800 – 148,850	25%	25%
\$ 148,850 – 226,850	28%	28%
\$ 226,850 – 405,100	33%	36.8%
\$ 405,100 – 457,600	35%	38.8%
Over \$457,600	39.6%	43.4%

¹The top three marginal rates in 2014 have the 3.8% NIIT added to them for any net investment income

Estates and Trusts

- The threshold for Trusts and Estates is \$12,150 (top tax bracket amount in 2014).
- Distributions to beneficiaries will carry out DNI.
- Charitable remainder trusts can be used to “smooth out” income.
- Non-grantor charitable lead trusts allow an “above the line” charitable deduction – IRC § 642(c) offsetting NIIT income.

Investment Income and MAGI Strategies

III. PLANNING CONSIDERATIONS

- A. Qualified retirement plans – reduce MAGI
- Contributions to 401(k) plans, 403(b) plans, 457 plans, IRAs, etc.
 - Creation of “alternative” qualified retirement plans (e.g. defined-benefit plans)
 - Roth conversions in years where income is lower
- B. Tax-exempt/tax-deferred investments – reduce MAGI and investment income
- Municipal bonds – remain tax exempt
 - Critical for trusts
 - 43.4% effective rate on taxable bonds
 - Tax-deferred non-qualified annuities (during deferral period)
 - “Leapfrog” over high income years
 - Part of MAGI and investment income during distribution period
 - Non-Qualified Deferred Compensation (NQDC)
 - Reduces investment income
 - Life insurance
 - Modified Endowment Contract (MEC) policies
 - Earnings withdrawal first
 - No policy loans
 - Non-MEC policies
 - Basis is withdrawn first
 - Loans are not taxable
 - No taxable income at death
 - Oil and gas
 - Immediate deduction of up to 95% of initial investment
 - Depletion allowances
 - Real estate investments
 - Depreciation tax shield reduces income
 - Security sales
 - Accelerate gains in years with low income
 - Collars
 - Merger shorts to generate capital losses
 - Dividend income
 - Timing of dividends
 - Return of capital dividends
 - Installment sales
 - Defer recognition of income over a period of time (to get under the MAGI threshold)
- C. Roth IRA conversions
- Roth IRA distributions will not count towards MAGI
 - Roth IRA conversion income does count towards MAGI
 - Payment of income tax using non-qualified accounts (i.e. “outside assets”) will generally result in lower future “net investment income”
 - The “NIIT Bubble” is a key concern
 - RMDs from Traditional IRAs
 - Exempt from the NIIT
 - Increase MAGI
 - Creates a 43.4% effective tax rate on IRA distributions
- D. Charitable trusts
- Charitable remainder trusts (CRTs)
 - Defer recognition of income over a period of time (to get under the MAGI threshold)
 - Smooth out spikes in income
 - Exempt from the NIIT
 - Non-grantor charitable lead trusts (CLTs)
 - Shift income away from grantor to trust – reduce MAGI
 - More tax efficient under the MAGI computation formula
 - Charitable deduction is “above” the line
 - No percentage limitations on charitable deductions



“NIIT Bubble”

Converting to a Roth today will reduce MAGI tomorrow – the “NIIT Bubble”

Example: Tom and Sue age 69 have “investment income” of \$249,000. Next year they are required to begin required minimum distributions. If they take an RMD of \$100,000 their MAGI will increase to \$349,000 and \$99,000 is subject to the NIIT.

YEAR 1

Investment Income	\$	249,000
IRA Distribution (i.e. RMD)		-
MAGI	\$	249,000
Less: Threshold		(250,000)
(2) Excess Over Threshold	\$	-

Amount Subject to the NIIT (Lesser of: 1 or 2 above)

NIIT (3.8%)	\$	-
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YEAR 2

Investment Income	\$	249,000
IRA Distribution (i.e. RMD)		100,000
MAGI	\$	349,000
Less: Threshold		(250,000)
(2) Excess Over Threshold	\$	99,000

Amount Subject to NIIT (Lesser of: 1 or 2 above)

NIIT (3.8%)	\$	3,762
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Net Investment Income Tax Examples

- John, single, has \$100,000 of salary and \$50,000 of net investment income.
 - The 3.8% NIIT would not apply (MAGI <\$200,000).
- Mary, single has \$225,000 of net investment income and no other income.
 - The 3.8% NIIT would apply to \$25,000 of income (excess of \$225,000 MAGI over \$200,000 "threshold amount").
- Terry and Tina, married filing jointly, have \$300,000 of salaries and no other income.
 - The 3.8% NIIT would not apply (no net investment income).
- Peter and Paula, married filing jointly, have \$400,000 of salaries and \$50,000 of net investment income.
 - The 3.8% NIIT would apply to \$50,000 of net investment income (lesser of rule).
- Scott and Sarah, married filing jointly, have \$200,000 of salaries and \$150,000 of net investment income.
 - The 3.8% NIIT would apply to \$100,000 of income (lesser of rule excess of \$350,000 MAGI over \$250,000 "threshold amount").
- Randy, a single taxpayer, age 69, has investment income of \$200,000 and is not subject to the NIIT. In the following year, Randy has an RMD from his IRA of \$125,000. In this case, \$325,000 MAGI exceeds the \$200,000 threshold and \$125,000 is subject to the 3.8% NIIT.

This is called the "NIIT bubble"

	Regular IRA	Roth IRA
Investment Income	\$ 200,000	\$ 200,000
IRA Income	\$ 125,000	\$ 0
MAGI	\$ 325,000	\$ 200,000
Less Threshold Amount	\$(200,000)	\$(200,000)
Amount Subject to NIIT	\$ 125,000	\$ 0
NIIT @ 3.8%	\$ 4,750	\$ 0
NIIT over 10 years	\$ 47,500	\$ 0

- The John Smith Trust has investment income of \$52,150 and no distributions.
 - \$40,000 of income (\$52,150 - \$12,150 top bracket amount) will be subject to the 3.8% NIIT
- David and Veronica, age 75, have pension and IRA income of \$750,000, \$25,000 of tax-exempt income and no taxable investment income. The 3.8% NIIT does not apply regardless of income because they have no net investment income.
 - A Roth conversion will be NIIT neutral.
- Jill, age 60, has wages and pensions of \$200,000 and interest income from CDs of \$300,000. She moves half of her investments into an annuity and purchases a life insurance policy with the remaining CDs.
 - In 2014 all of her interest is sheltered in either the annuity or the life insurance policy and she is not subject to the 3.8% NIIT.
- Eliot, a widower, earns wages of \$175,000 and owns an interest in a publicly traded real estate partnership which generates taxable income of \$50,000.
 - \$25,000 (excess of \$225,000 MAGI over \$200,000 "threshold amount") will be subject to 3.8% NIIT.

- Larry, a widower, earns wages of \$175,000 and owns an interest in a closely-held real estate partnership which generates taxable passive income of \$75,000.
 - His MAGI is \$250,000 and \$50,000 will be subject to the NIIT (lesser of rule).
- Bruno, a single person, earns wages of \$200,000 and receives royalties of \$60,000 from an oil and gas limited partnership.
 - \$60,000 will be subject to the NIIT (excess of \$260,000 MAGI over \$200,000 "threshold amount").
- Mary and David earn wages of \$260,000 and receive a trust distribution of \$90,000 (100% dividends).
 - \$90,000 (net investment income) will be subject to the 3.8% NIIT
- The estate of Jane Smith earned \$112,150 of dividends and made no distributions.
 - Assuming a threshold exemption of \$12,150, \$100,000 will be subject to the 3.8% NIIT.
- The estate of Jane Smith earned \$112,150 of interest and made a distribution of 100% of income.
 - The income will be reported by the heirs and the estate will not be subject to the 3.8% NIIT.
- Bob and Bonnie have interest income of \$248,000 and no other income. They convert Bob's \$300,000 IRA to a Roth IRA which increases AGI to \$548,000.
 - Under the lesser of rule, \$248,000 will be subject to the 3.8% NIIT; this is the lesser of \$298,000 of excess MAGI (\$548,000 - \$250,000) or \$248,000 of investment income.
- Randy converts a \$1,000,000 IRA to a Roth IRA incurring \$450,000 of state and federal income tax. Randy pays the income taxes from his outside/taxable investment funds.
 - Future investment income from the outside funds will no longer exist and avoid the 3.8% NIIT.
- Daniel and Donna have wages of \$250,000 and investment income of \$45,000. Their employer creates a new deferred compensation plan allowing a contribution of up to 20% of income (i.e. \$50,000).

2014	Without Planning	With Planning
Wages	\$ 250,000	\$ 200,000
Investment Income	\$ 45,000	\$ 45,000
MAGI	\$ 295,000	\$ 245,000
Threshold	\$ 250,000	\$ 250,000
Amount Subject to NIIT	\$ 45,000	\$ 0
NIIT @ 3.8%	\$ 1,710	\$ 0
NIIT over 10 years	\$ 17,100	\$ 0
NIIT Savings		\$ 17,100

- Gary and Barb, age 69, have pension income of \$130,000 and investment income of \$115,000 for a total MAGI of \$245,000, just below the threshold amount. In 2014, their Roth IRA withdrawal will be \$50,000.
 - No 3.8% NIIT will apply because the \$50,000 Roth IRA distribution does not count towards MAGI.
- Thor and Kristen, age 69, have pension income of \$100,000 and net investment income of \$75,000 for a total MAGI of \$175,000, well below the \$250,000 threshold amount.
 - In 2014, their RMDs will be \$50,000 bringing MAGI to \$225,000, which is still below the threshold amount.
- Art and Patricia, age 69, have pension income of \$130,000 and net investment income of \$115,000 for a total MAGI of \$245,000, just below the threshold amount. In 2014, their RMDs from their IRAs will be \$50,000, which brings their MAGI to \$295,000.
 - MAGI is \$45,000 above the threshold amount (\$295,000 less \$250,000).
 - The NIIT will be imposed on the lesser of \$45,000 or their net investment income of \$115,000. (i.e., \$45,000).
- Same facts, except they convert in 2014 and the pension is \$30,000. The conversion would be added to MAGI of \$195,000 and their entire net investment income of \$115,000 will be subject to the NIIT.

2013	Without Conversion	With Conversion
(1) Pension Income	30,000	30,000
IRA Distribution (i.e. RMD)	50,000	50,000
Roth IRA Conversion		200,000
Investment Income	115,000	115,000
MAGI	\$ 195,000	\$ 395,000
Less: Threshold	(250,000)	(250,000)
(2) Excess Over Threshold	\$ (55,000)	\$ 145,000
Amount Subject to Medicare Surtax (Lesser of: 1 or 2 above)	\$ -	\$ 115,000
Medicare Surtax (3.8%)	\$ -	\$ 4,370

- Brian and Betty, age 69, have annual pension income of \$260,000 and net investment income of \$115,000 for a total gross income and MAGI of \$375,000. In 2014, their RMDs from IRAs will be \$50,000 bringing MAGI to \$425,000.
 - Because their "fixed" non-investment income of \$260,000 (e.g. pensions) is over the \$250,000 threshold amount, their NIIT reduction planning must focus on reducing net investment income, not on reducing MAGI.

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