What You Need to Know About the 3.8% Net Investment Tax

If only the rules were as basic as the math

By Janice Eiseman

Key Takeaways:

- The net investment income tax is an "overlay" on the regular income tax; that is, the net investment income tax, which is computed on Form 8960, cannot be computed until Form 1040 (individual) or Form 1041 (trust or estate) is completed.
- The purpose of the tax is to make the hospital insurance tax (referred to as the "Medicare tax") imposed on self-employment income (earned income) applicable to unearned income. The top rate of the hospital insurance tax on earned income is 3.8 percent.
- The tax was effective for taxable years starting after December 31, 2012.

READER NOTE—*Janice is happy to answer your questions at jeiseman@cl-law.com.*

As most advisors know, it is important to realize that the new 3.8 percent investment income tax applies only to certain individuals, trusts and estates. To be applicable, taxpayers subject to the tax must meet threshold levels of "modified adjusted gross income" for individuals or adjusted gross income for trusts and estates. Modified adjusted gross income means an individual's adjusted gross income ("AGI") plus any foreign earned income and housing cost amount an individual elects to exclude from gross income for federal income tax purposes minus any associated deductions. Thus, in most cases, modified adjusted gross income is the same as an individual's AGI reported on Line 37 of Form 1040. For purposes of this article, we will assume that "modified adjusted gross income" is the same as "AGI." The threshold amounts are as follows:

1. Only those individuals with AGI in excess of the following amounts are subject to the new tax: $250,000 for married filing jointly or a "qualifying widower" with a dependent child; $125,000 for married filing separate returns; and $200,000 for any other individual, e.g., an unmarried individual.
2. Only trusts and estates with adjusted gross income in excess of the amount of taxable income subject to the highest applicable marginal tax bracket are subject to the new tax. For 2014, that amount was $12,150. In 2015 it rose to $12,300 and in 2016 it is $12,400.

If you are married filing a joint return with AGI equal to or less than $250,000, you do not have to worry about the 3.8 percent investment income tax. However, if you have a trust and the trust is subject to the investment income tax (that is, it is not an excluded trust listed in the next paragraph), then that trust will be subject to the tax at the very low threshold amount, $12,400. The difference in the threshold amounts for a trust and for an individual makes it important to look at the income tax brackets of the beneficiaries of the trust. If they are in a lower income tax bracket than the trust, you should consider distributing money to the beneficiaries to lower the amount the trust may have to pay under the 3.8 percent investment income tax.

The trusts and estates excluded from the net investment income tax are the following:

- Charitable remainder trust
- Qualified retirement trust exempt from federal income tax
- Trust, or portion thereof, treated as a grantor trust (reason for grantor trust status is irrelevant)
- Foreign trusts or estates
- A trust or decedent's estate in which all the unexpired interests are devoted to religious, charitable, scientific, literary or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals
- Electing Alaska Native Settlement Trust
- Cemetery perpetual care funds
- Any other trust, fund or account that is statutorily exempt from income tax, e.g., college tuition trust under Section 529 of the Internal Revenue Code of 1986, as amended (the "Code")

Note that income in IRAs and profit sharing plans is *not* subject to the 3.8 percent tax—a very favorable outcome for these types of investments that your client should be aware of.

Example

Assuming that you meet the threshold test, you and your advisor must then determine which income the tax specifically applies to. For individuals, you multiply 3.8% by the *lesser* of their (i) net investment income or (ii) AGI over the threshold amount. For example, if you have AGI of $300,000 and net investment income of $75,000, then the 3.8 percent tax will be applied to $50,000 (i.e., $300,000 minus the $250,000 threshold). Thus, the tax will be equal to $1,900 (i.e., 3.8% x $50,000). If your adjusted gross income is $500,000 and your net investment income is $100,000, then the 3.8 percent tax is applied to $100,000, yielding a tax of $3,800 (i.e., 3.8% x $100,000).

For trusts and estates, 3.8 percent is multiplied by the lesser of (i) *undistributed* net investment income or (ii) adjusted gross income (as defined in Section 67(e) of the Internal Revenue Code of 1986, as amended (the "Code") over the threshold amount. Net investment income distributed to a beneficiary is subject to tax at the beneficiary level.

We can see that to calculate the tax, you must know which income is considered "investment income." Surprisingly, the provision governing the tax, set forth in Code Section 1411, is short. Section 1411(c)(1)(A) provides that three buckets of income are included in the investment income tax base. The goal of these three buckets is to aggregate all the investment income reported on a Form 1040 or Form 1041. Because the tax is imposed on "*net* investment income," the deductions allowed under the regular income tax law, which are properly allocable to investment income, must be determined. I.R.C. § 1411(c)(1)(B). Thus, the task boils down to making the proper adjustments to income and gain reported on Form 1040 or Form 1041 to determine "investment income," as defined in Section 1411(c)(1)(A), and then deducting from that amount the deductions that are properly allocated to it under Section 1411(c)(1)(B). **Note:** “Net investment income,” as defined in Section 1411 is *not* the same as “net investment income” defined in Code Section 163(d)(4) for purposes of determining the investment interest deduction under Code Section 163(d).

Conclusion

In future articles, we’ll take a closer look at each of the three buckets of income.

About the Author

__Janice Eiseman__ is a tax partner at __Cummings & Lockwood__ specializing in income tax issues associated with small businesses with a particular emphasis on the income taxation of pass through entities such as partnerships and limited liability companies. She also advises clients on many other state and federal income tax issues.