

**Abstract:** Individual taxpayers are potentially liable for the net investment income tax (NIIT) if their modified adjusted gross income (MAGI) exceeds \$200,000 (\$250,000 for joint filers and qualifying widows or widowers; \$125,000 for married taxpayers filing separately). This article explains how NIIT is calculated and offers several planning strategies taxpayers can use to minimize a tax hit.

## **Planning for net investment income taxes**

The 3.8% net investment income tax (NIIT) is an additional tax that applies to some higher-income taxpayers on top of capital gains tax or ordinary income tax. Fortunately, there are strategies you can use to soften the blow of the NIIT.

### **Are you subject to the NIIT?**

You're potentially liable for the NIIT if your modified adjusted gross income (MAGI) exceeds \$200,000 (\$250,000 for joint filers and qualifying widows or widowers; \$125,000 for married taxpayers filing separately). Generally, MAGI is the same as adjusted gross income. However, it may be higher if you have foreign earned income and certain foreign investments.

The NIIT is calculated by multiplying 3.8% by the *lesser* of:

- 1) net investment income (NII), or
- 2) the amount by which MAGI exceeds the applicable threshold.

For example, if you're single with \$250,000 in MAGI and \$75,000 in NII, your MAGI will exceed the \$200,000 threshold for singles by \$50,000, which is less than your NII. So, your NIIT will be  $3.8\% \times \$50,000$ , which equals \$1,900.

But if your MAGI instead is \$300,000, your NIIT will be  $3.8\% \times \$75,000$ , which equals \$2,850. This is because your \$75,000 NII is less than the \$100,000 amount by which your MAGI will exceed the \$200,000 threshold.

NII generally includes net income from taxable interest, dividends, capital gains, rents, royalties and passive business activities. Several types of income are excluded from NII, such as wages, most nonpassive business income, retirement plan distributions and Social Security benefits. Also excluded are alimony and nontaxable gain on the sale of a personal residence.

### **Planning strategies**

Given the way the NIIT is calculated, you can reduce or defer the tax by reducing either your MAGI or your NII. Consider:

- Deferring income to next year,
- Maximizing contributions to IRAs and qualified retirement plans,
- Reducing your capital gains by selling investments at a loss, or

- Investing in tax-exempt municipal bonds or in growth stocks that pay little or no dividends.

You also might be able to transfer — either directly or in trust — assets that generate investment income to lower-income family members who aren't subject to the NIIT. With this strategy, though, be careful not to inadvertently trigger NIIT because of the transfer. For example, trusts have a dramatically lower income threshold level at which NIIT applies.

If you own rental real estate, talk to your tax advisors about how you can avoid NIIT and obtain other tax benefits by qualifying as a materially participating “real estate professional.”

If you hold interests in pass-through entities — such as partnerships, limited liability companies and S corporations — it's important to consider the interplay between the NIIT and other taxes. For instance, it may be possible to avoid the NIIT by increasing your level of participation to convert a pass-through investment from passive to nonpassive. But in some cases, doing so may also trigger self-employment (SE) or payroll taxes, so it's important to weigh the NIIT savings against the potential SE or payroll tax costs.

### **Handle with care**

There are many potential strategies for reducing or deferring NIIT, but it's important to consult with your tax advisor before you implement them. Tax reduction is an important objective, so long as it doesn't come at the expense of prudent investment decision-making.