Tax Insights

Wealth Management

Plan Around the Net Investment Income Tax

THE 3.8 PERCENT NET INVESTMENT INCOME TAX took effect at the beginning of 2013. It only affects higher-income individuals, but that can include anyone who happens to have big one-time taxable income or gains in one year. This article covers some planning strategies that individuals can implement to avoid or minimize the tax.

Net Investment Income Tax Basics

THE FOLLOWING TYPES of income and gain (net of related deductions) are generally included in the definition of net investment income and thus potentially exposed to the 3.8 percent tax.

- Gains from selling assets held for investment including gains from selling investment real estate and the taxable portion of gains from selling personal residences.
- Capital gain distributions from mutual funds.
- Gross income from dividends and interest (not including tax-free interest such as municipal bond interest).
- Gross income from annuities and royalties.
- Gross income and gains from passive business activities (in which you do not materially participate) and gross income from rents. Gross income from non-passive business activities is excluded from the definition of net investment income and so is gain from selling property held in such activities.
- Gains from selling passive partnership interests and S corporation stock (meaning you do not materially participate in the partnership or S corp's business activities).
- Gross income and gains from the business of trading in financial instruments or commodities (whether you materially participate or not).

Affected Individuals

YOU ARE ONLY EXPOSED to the 3.8 percent Medicare tax if your modified adjusted gross income (MAGI) exceeds: $200,000 if you're unmarried, $250,000 if you're a married joint-filer or qualifying widow or widower, or $125,000 if you use married filing separate status.

The amount subject to the 3.8 percent tax is the *lesser* of:

1. Your net investment income or
2. The amount by which your MAGI exceeds the applicable threshold.

For this purpose, MAGI is defined as regular AGI from the bottom of page 1 of your Form 1040 plus certain excluded foreign-source income net of certain deductions and exclusions (relatively few individuals are affected by this add-back). *Note:* The 3.8 percent tax can also hit estates and trusts that have investment income but we will not cover them in this article.

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Five Long-Term Strategies to Avoid or Reduce the New Tax

The following ideas may not reduce or eliminate this year's exposure to the new 3.8 percent Medicare tax, but they could help a lot over the long run.

1. Convert traditional retirement account balances to Roth accounts, but watch out for the impact on your MAGI in the conversion year. *Reason:* The deemed taxable distributions that result from Roth conversions aren't included in your net investment income, but they increase MAGI, which may expose more of your investment income to the 3.8 percent tax.

Over the long haul, however, income and gains that build up in a Roth IRA usually avoid the 3.8 percent tax, because qualified Roth distributions are tax-free. Because qualified distributions are not included in your MAGI (unlike the taxable portion of distributions from other types of tax-favored retirement accounts and plans), they won't increase exposure to the 3.8 percent tax by increasing your MAGI.

2. Invest taxable accounts in tax-exempt bonds. This would reduce both net investment income and MAGI. Use tax-favored retirement accounts to invest in securities that are expected to generate otherwise-taxable gains, dividends, and interest.

3. Invest in life insurance products and tax-deferred annuity products. Life insurance death benefits are generally exempt from federal income tax and are thus exempt from the 3.8 percent Medicare tax too. Earnings from life insurance contracts are not taxed until they are withdrawn. Similarly, earnings from tax-deferred annuities are not taxed until they are withdrawn.

4. Invest in rental real estate and oil and gas properties. Rental real estate income is offset by depreciation deductions, and oil and gas income is offset by deductions for intangible drilling costs (IDC) and depletion. These deductions can reduce both net investment income and MAGI.

5. Invest taxable accounts in growth stocks. Gains are not taxed until the stocks are sold. At that time, the negative tax impact of gains can often be offset by selling loser securities held in taxable accounts. In contrast, stock dividends are taxed currently, and it may not be so easy to offset them.

Planning Strategies Must Aim at Proper Target

SINCE THE 3.8 PERCENT MEDICARE TAX hits the lesser of: your net investment income or the amount by which your MAGI exceeds the applicable threshold, planning strategies must be aimed at the right target.

- If your exposure to the tax mainly depends on your net investment income, focus first on strategies that will minimize that amount.
- If your exposure to the tax mainly depends on your MAGI, concentrate on strategies that will reduce that number.

Here are three examples to illustrate different taxpayers' situations.

Example 1: Target Net Investment Income

YOU WILL FILE AS an unmarried individual. Unless something changes, you will have \$370,000 of MAGI, which includes \$95,000 of net investment income. You will owe the 3.8 percent Medicare tax on all net investment income (the lesser of your excess MAGI of \$170,000 or your net investment income of \$95,000).

Your exposure to the 3.8 percent tax mainly depends on your net investment income level. Therefore, you should focus first on strategies to reduce that amount. For instance, you could sell loser securities from your taxable brokerage firm investment accounts to offset earlier gains. Additional strategies are explained later in this article.

In contrast, strategies that would lower your MAGI would *not* reduce your exposure to the 3.8 percent tax unless they reduce your MAGI by a whole lot. For instance, making an additional $15,000 deductible contribution to your tax-favored retirement account would not by itself reduce your exposure to the 3.8 percent tax.

Example 2: Target MAGI

YOU AND YOUR SPOUSE will file jointly. You plan to have $325,000 of MAGI, which includes $100,000 of net investment income. You will owe the 3.8 percent Medicare tax on $75,000 (the lesser of your excess MAGI of $75,000 or your net investment income of $100,000).

Your exposure to the tax mainly depends on your MAGI level. Therefore, you should focus there first. For instance, making $25,000 of additional deductible contributions to your tax-favored retirement accounts would reduce your MAGI by $25,000 and therefore reduce the 3.8 percent tax. Selling loser securities from your taxable brokerage firm accounts to offset earlier gains would also reduce your MAGI.

In contrast, using a method that allocates more deductions to offset your investment income would *not* reduce your bill for the 3.8 percent tax unless the method reduces your net investment income amount by a great deal, which is not likely

Example 3: Reduce the Impact of One Big Transaction

YOU AND YOUR SPOUSE will file jointly. Between now and year end, you expect to sell a greatly appreciated vacation home, which you've owned for many years. The whopping $650,000 gain will be fully taxable for federal income tax purposes and will also count as investment income for purposes of the 3.8 percent tax. Let's assume you'll have no other investment income and no capital losses. But you'll have $150,000 of MAGI from other sources (salary, bonuses, self-employment income, and so forth).

Due to the vacation home profit, your net investment income will be $650,000 (from the sale) and your MAGI will $800,000 ($650,000 from the vacation home plus $150,000 from other sources). You would owe the 3.8 percent tax on $550,000, which is the lesser of: your net investment income of $650,000 or your excess MAGI of $550,000. In this case, that means $800,000 minus the $250,000 threshold for joint-filing couples. The 3.8 percent tax would amount to $20,900 (3.8 percent times $550,000). Ouch!

In this example, the sole source of your exposure to the tax is the vacation home gain. Therefore, consider the following strategies:

- Sell the vacation home on an installment plan to spread the gain over several years and thus minimize or maybe even eliminate exposure to the tax.
- If possible, swap the vacation home in a Section 1031 “like-kind exchange,” which would defer the big gain and completely eliminate your exposure to the 3.8 percent tax for now.
- Take other steps (described below) to reduce your net investment income, which would reduce your exposure to the tax.

Proactive Planning Can Pay Off

SOME OF THE STRATEGIES described are doubly effective because they can reduce your regular federal income tax bill as well as the 3.8 percent Medicare tax. If you're self-employed, some of the ideas can amount to tax-saving triple plays because they can also reduce your self-employment tax bill. Finally, they might reduce your state income tax bill as well. However, some of these strategies take time to implement. So talk with your tax adviser *now*.

Strategies to Reduce Net Investment Income *and* MAGI

Sell loser securities held in taxable accounts to offset earlier gains from such accounts.

Gift soon-to-be-sold appreciated securities to children or grandchildren and let them sell the securities to avoid including the gains on your return. But beware of the Kiddie Tax, which can potentially apply until the year your child or grandchild turns age 24. Talk with your tax adviser to ascertain if the Kiddie Tax might be an issue in your case.

Instead of cash, **gift appreciated securities** to IRS-approved charities. That way, the gains won't be included on your return.

If possible, **defer gains subject to the 3.8 percent tax** by making installment sales or Section 1031 like-kind exchanges.

Strategies to Reduce Net Investment Income

Select a method for determining deductions allocable to gross investment income that will maximize such deductions and thereby reduce your net investment income. Your tax adviser can help find the best method.

If possible, **become more active in rental and business activities** (including those conducted through partnerships and S corporations) to "convert" them from passive to non-passive by meeting one of the material participation standards. That would make income from the activities exempt from the 3.8 percent tax, because it doesn't apply to income from non-passive business activities (including non-passive rental activities). Ask your tax adviser for details.

To facilitate the preceding strategy, **consider taking advantage** of the one-time opportunity to regroup activities for purpose of applying the passive activity rules. Once again, your tax adviser can provide details.

Strategies to Reduce MAGI

Maximize deductible contributions to tax-favored retirement accounts such as traditional IRAs, 401(k) accounts, self-employed SEPs, and self-employed defined benefit pension plans.

Note: You can make a deductible contribution to a traditional IRA right up until the April 15 filing date and still benefit from the resulting tax savings on your previous year's return. Small business owners can set up and contribute to a Simplified Employee Pension (SEP) plan for the year up until the due date for their returns, including extensions.

if you're a cash-basis self-employed individual, defer business income into the next year and accelerate business deductions into the current year. Consult with your tax adviser for specific information.

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