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TO: OUR CLIENTS AND FRIENDS

FROM: JACKSON M. PAYNE

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RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

NET INVESTMENT INCOME TAX

Many Americans don't know Uncle Sam has an extra tax on investment income for higher earners—at least until they owe it. This levy is called the net investment income tax, or NIIT for short. It's a 3.8% surtax on a filer's income from sources like interest, dividends and capital gains that applies if adjusted gross income or AGI, is above $200,000 for most single filers or $250,000 for most married couples.

It affects one-time spikes as well as recurring income, so taxpayers who typically earn less can owe it on a windfall. Although the 3.8% rate is low, the NIIT deserves a close look because even small taxes can affect investment decisions. And the NIIT's reach is expanding.

When lawmakers enacted it to help fund the Obama-care health-coverage expansion, they chose not to adjust the $200,000/$250,000 thresholds for inflation to collect more tax.

(a) The 3.8% surtax applies to net capital gains on asset sales (including cryptocurrency), dividends, interest (including on CDs and bank accounts) and royalties, among other things. It also applies to net gains on the sale of a home above the exemption of $250,000 for single filers and $500,000 for joint filers. Rental income can be subject to the tax as well, unless it's from an actively managed real estate business.

(b) Wages, pensions, Social Security payments and taxable retirement-plan payouts aren't themselves subject to NIIT, but they can help trigger it as described below. Tax-free municipal-bond income is exempt as well. Income from actively managed businesses such as partnerships and S corporations doesn't count either.

(c) Because investment income "stacks" on top of the filer's other income, wages, IRA withdrawals and other taxable income can help push investment income over the NIIT threshold.

Strategies to Consider

Tax-deductible contributions to traditional IRAs, 401(k)s or Health Savings Accounts all help to lower AGI, which can reduce the surtax. By contrast, Schedule A deductions like mortgage interest, medical expenses and charitable donations don't reduce NIIT as they don't lower AGI.

For older taxpayers taking required IRA payouts who are charitably minded, making donations with Qualified Charitable Distributions from a traditional IRA can help. Donors can give up to $100,000 of IRA assets per year to one or more qualified charities and count the donations toward their required payouts, keeping that income out of AGI.

For savers considering converting traditional IRA assets to Roth IRAs, the 3.8% surtax, can be a factor in favor of conversion. Tax-free payouts from Roth IRAs don't raise AGI or the 3.8% surtax, and there are not required payouts for the account owner. The conversion also helps reduce required payouts from traditional IRAs.

Investors should also evaluate tax-free municipal bonds or muni-bond funds, as their income is exempt from the surtax.

With higher yields, there's more benefit to holding fixed-income assets in tax-deferred retirement accounts as opposed to taxable accounts. Actively managed mutual funds often belong in tax-deferred accounts as well.

Consider harvesting losses to offset taxable capital gains on sales of profitable assets, including the sale of a home with gains above the $250,000/$500,000 exemption. Losses can also offset tax on $3,000 of ordinary income such as wages a year, and unused losses carry forward for future use.