
3.8% Tax on Net Investment Income

A 3.8% tax on “Net Investment Income” applies to certain individual taxpayers, estates, and trusts. This tax is in addition to any other federal income tax, including the Alternative Minimum Tax (AMT).¹

Individual Taxpayers

For individual taxpayers, the tax applies to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over a specified threshold amount.² The threshold amounts vary with taxpayer filing status:

Taxpayer Filing Status	Threshold Amount
Married Filing Jointly, Surviving Spouse	\$250,000
Married Filing Separately	\$125,000
Single, Head of Household	\$200,000

For these purposes, MAGI is a taxpayer’s regular adjusted gross income (AGI) increased by certain foreign earned income. Those with a MAGI below these thresholds, or with no net investment income, will not be subject to the 3.8% tax.

Estates and Trusts

In the case of an estate or trust, the tax is 3.8% of the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins. For 2021, the highest income tax bracket applicable to an estate or trust begins at \$13,050; for 2020, it was \$12,950.

The tax does not apply to a trust in which all the unexpired interests are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under IRC Sec. 501 or a charitable remainder trust (CRT) exempt from tax under IRC Sec. 664. Also excluded are “grantor trusts” under IRC Sections 671-679, real estate investment trusts, and common trust funds.

¹ The discussion here concerns federal income tax law. State or local income tax law may differ.

² The threshold amounts are not subject to adjustment for inflation.

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Net Investment Income

“Net” investment income is “investment income” less allowable “investment expenses.”

Investment income includes:

- Interest and dividends.
- Non-qualified annuities, including amounts received under IRC Sec. 72(a), 72(b), and 72(e).
- Royalties, including mineral, oil, and gas royalties, as well as amounts received for the use of patents, copyrights, formulas, goodwill, and similar types of property.
- Rents: amounts paid for the use of tangible property.¹
- Gross income from a trade or business that is considered a “passive activity” with respect to the taxpayer.
- Gross income from a trade or business of trading in financial instruments or commodities.
- Net gain from the disposition of property: Generally, investment income includes the “net” (but not below zero) recognized gain on the disposition of property. It does not include gain deferred or excluded from regular income tax under various code sections such as IRC Sec. 121 (principal residence sale exclusion), IRC 1031 (like-kind exchanges), IRC Sec. 1033 (involuntary conversions), IRC Sec. 1035 (exchanges of life insurance or annuity contracts), or IRC Sec. 453 (installment sales). It also does not include gain from property held in a trade or business to which the tax does not apply.
- Disposition of a partnership interest or S corporation stock: In general, a “deemed sale” rule applies. Gain or loss is included in investment income only to the extent that net gain or loss would be taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of the interest.

¹ The first four items are not included in investment income if they are derived from any trade or business to which the tax does not apply.

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- Working capital: Income, gain, or loss from an investment in working capital is included in investment income.
- Investments in foreign corporations: Generally, income with respect to investments in foreign corporations is included in investment income.

Note: Investment capital income does not include any income subject to self-employment tax.

Allowable investment expenses include:

- Investment interest expense.¹
- Investment advisory and brokerage fees.¹
- Expenses related to rental and royalty income.
- State and local income taxes properly allocable to items included in investment income.

Income NOT Included in Net Investment Income

A number of income items are not considered investment income, including:

- Operating income from a business in which the taxpayer is an active participant, such as a sole proprietor, partnership, or S corporation.
- Social Security and veterans' benefits.
- Alimony.
- Tax-exempt interest income.
- Distributions from certain qualified retirement plans.
- Alaska Permanent Fund Dividends.

¹ Under the provisions of the Tax Cuts and Jobs Act of 2017 (JCTA), for tax years 2018-2025, neither investment interest expense nor advisory and brokerage fees are deductible expenses on a taxpayer's Schedule A. Thus, they are also not deductible for the purpose of the 3.8% tax on Net Investment Income. This change will have the effect of increasing the amount of Net Investment Income potentially subject to the 3.8% surtax.

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Other Issues

There are a number of other issues surrounding the 3.8% Tax on Net Investment Income that taxpayers should keep in mind:

- **Kiddie Tax:** If a dependent child has unearned income (such as interest, dividends, or capital gains) which the taxpayer chooses to include on his or her income tax return through Form 8814 (Parent's Election to Report Child's Interest and Dividends), the net amounts of this unearned income are included in calculating whether or not the parents' income is subject to this tax.
- **Estimated tax provisions:** For taxpayers potentially subject to this tax, the estimated tax provisions apply; either salary withholding should be increased, or estimated quarterly payments made.
- **How reported and paid:** The tax is calculated and reported on Form 8960. For individuals, Form 8960 is attached to Form 1040. For estates and trusts, Form 8960 is attached to Form 1041.
- **Taxpayers subject to the tax:** The tax generally applies to all U.S. citizens and resident aliens. If a U.S. citizen is married to a non-resident alien, the U. S. citizen will be treated, for the purposes of the tax, as if they were using the "married-filing-separately" filing status, with a \$125,000 threshold. A special election can be made to treat the non-resident alien spouse as a resident alien, subjecting the couple's world-wide income to U. S. tax and increasing the threshold for the Unearned Income Medicare Contribution Tax to \$250,000. Residents of Guam, the Northern Mariana Islands, the U.S. Virgin Island, American Samoa, and Puerto Rico are subject to special rules.

Seek Professional Guidance

The foregoing is a summary of a complex set of tax rules. The advice and guidance of knowledgeable income tax and other financial professionals is strongly recommended.