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Net investment income tax

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One of the new taxes created by the fiscal cliff legislation that has not received as much attention as it should is the net investment income tax. This 3.8% tax is imposed on individuals, estates and trusts. For individuals, the tax applies when adjusted gross income exceeds $200,000 for an individual return and $250,000 for a joint return. For estates and trusts, the tax applies when adjusted gross income exceeds a measly $13,000.

The new tax applies to a remarkably broad class of income, including dividends, interest, annuities, royalties and rents that are not derived in the ordinary course of a trade or business. It applies to all passive income, which includes rental income (with some exceptions) and all other income from a trade a trade or business in which the income recipient does not materially participate. Income derived from trading in stocks, equity, debt, options, derivatives and commodities, and gain from the sale of property generating investment income is also subject to the tax.

Deferred gain on a Section 1031 exchange is not subject to the tax. Additionally gain on the sale of a home is not subject to the tax to the extent that the gain does not exceed $500,000 for a joint return and $250,000 for an individual return. Further, losses on the sale of property and casualty, theft and abandonment losses are deductible against the net investment tax gain. A net loss on net investment tax in one year cannot be carried over to a subsequent year to offset net investment gain in that subsequent year.

Overall, the net investment income tax will increase the marginal tax rate for many taxpayers and will likely come as quite a surprise to them. The remarkably low threshold for trust investment income may even cause some taxpayers to reconsider their use of trusts for the purpose of holding real estate interests. If you own interests in real estate through partnerships or S corporations, you should contact your tax advisor to see how the new tax will apply to you.

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