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It's All About Planning: Smart Ways to Reduce Net Investment Income Tax

As part of the Affordable Care Act, many taxpayers have been paying two new taxes since 2013.

The Additional Medicare Tax is a 0.9 percent flat tax on earned income for taxpayers with wages or self-employment income in excess of $200,000 (or $250,000 for married taxpayers filing jointly and $125,000 for married taxpayers filing separately).

The Net Investment Income Tax (or NIIT) is a 3.8 percent flat tax on the lesser of net investment income for the tax year or modified adjusted gross income (MAGI) in excess of $200,000 (or $250,000 for married taxpayers filing jointly and $125,000 for married taxpayers filing separately).

Taxable "net investment income" includes income from interest, dividends, annuities, royalties and rents, plus realized capital gains attributable to the sale of investment properties. It also includes income from passive activities or from a trade or business activity in financial instruments or commodities, and income on investment of working capital subject to tax.

Planning Opportunities

The IRS's final regulations exclude certain types of income from the NIIT, which is where the planning opportunities lie for manufacturing and distribution company owners. While the IRS declined to list specific types of income excluded from the NIIT, the regulations generally exclude:

- Earned income, including wages and self-employment income.
- Active trade or business income.
- Distributions from qualified retirement plans.
- Interest on municipal bonds.
- The excludable portion of gain on the sale of a primary residence.
- Gains from the sale of a partnership or S corporation under the deemed asset sale rule if you are active in the business.

The best way to reduce your NIIT exposure is to work with your tax advisor to minimize income that's subject to the NIIT and maximize the types of income that are excluded. For example:

- **Get active.** To minimize income from "passive" activities, become active by materially participating in a way that is "regular, continuous and substantial." If you are about to sell your partnership or S corporation, stay active in the business and exclude that portion of your gain attributable to the active trade or business.

- **Regroup.** Subject to various limitations, the final regulations allow taxpayers to "regroup" their passive and active activities to take advantage of certain income tax benefits. For purposes of the NIIT, you may be able to regroup passive activities in a way that will establish material participation in a trade or business. This would make the previously passive income active and not subject to the NIIT. Your tax advisor can offer details on the intricacies and procedural requirements of regrouping and how it might work for you.
- **Time distributions.** IRA and retirement plan distributions aren't subject to the NIIT, but they may put you over the MAGI limit. If this is a concern, work with your tax advisor to time distributions appropriately. Note that Roth IRA distributions have no impact on MAGI, so converting regular IRAs to Roth IRAs could be a viable strategy.
- **Consider muni bonds.** Income from municipal bonds isn't subject to NIIT, so consider adding these investments to your portfolio.

Start Planning Now

Mitigating the tax impact of the NIIT will require ongoing planning. Be sure to talk with your Mueller Prost advisor before taking any action.

We hope you find this information valuable. Contact us to discuss your NIIT planning opportunities and any other questions or needs you may have as year-end draws near.

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