The ‘You-Make-a-Lot-of-Money Tax’ Hits More Americans

The net investment income tax is coming due for millions more taxpayers than a decade ago. That’s no accident.

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Many Americans don’t know Uncle Sam has an extra tax on investment income for higher earners—at least until they owe it. Now more people are owing it, thanks to inflation and higher yields on bank accounts and bonds.

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 such as whether to choose tax-free municipal bonds over taxable bonds or do a Roth IRA conversion.

And the NIIT’s reach is expanding. When lawmakers enacted it to help fund the Obamacare health-coverage expansion, they chose not to adjust the $200,000/$250,000 thresholds for inflation to collect more tax.

As a result, NIIT revenue has more than tripled since the tax took effect in 2013, rising from $16 billion to more than $60 billion in 2021, according to the Internal Revenue Service’s latest data. Over that period the number of taxpayers owing it more than doubled, from about 3 million to about 7 million. Had the $200,000/$250,000 thresholds been indexed for inflation, they would be closer to $264,000 and $330,000.

Higher yields on money-market funds and taxable bonds—some are paying more than 5%—are also pushing filers into NIIT territory. Bridget Sullivan Mermel, a CPA and fee-only planner in Chicago, says that every year more of her firm’s clients are subject to the surtax.

“Maybe $114 is a small price to pay when your interest on a “safe” investment of $100,000 rises from $1,000 to $4,000, but it’s there. I joke to clients that the NIIT is the ‘you-make-a-lot-of-money tax,’ ” she says.

With planning, some taxpayers can avoid the 3.8% surtax, while others may only be able to reduce it. Here’s more to know if you’re grappling with NIIT.

What income counts

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.

What income doesn't count

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, says David Kirk, a member of the American Institute of CPAs who supervised development of NIIT regulations when he worked at the IRS.

But this may change, as the Biden administration wants to make such income subject to the NIIT.

How the NIIT applies

The 3.8% surtax is a levy on a taxpayer's net investment income that raises the filer's marginal rate on it. However, the tax only applies above AGI thresholds of $200,000 for single filers and $250,000 for joint filers.

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.

What moves have you considered to reduce how much net investment income tax you owe? Join the conversation below.

Here are examples. Lee and Dana are a retired couple with $245,000 of AGI from pensions, Social Security and required IRA payouts. They also have $15,000 of taxable interest from bonds, CDs and bank accounts. Because their income is $245,000, $5,000 of their interest isn't subject to the NIIT but $10,000 is—because it's above $250,000. On that slice, the couple's 24% rate rises to 27.8%, and they'll owe $380 more tax.

Dan, a single filer, has $150,000 of AGI from wages, and he sells inherited stock with $80,000 of gains to help pay his child's college tuition. He owes NIIT on the $30,000 of gains above $200,000 of AGI, raising his 15% capital-gains rate on this amount to 18.8% and adding $1,140 of tax.

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 aren't 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. Michael Hoyle, an adviser with Conrad Siegel in Harrisburg, Pa., says his firm checks out munis for all clients in the 24% income-tax bracket or above and even some in the 22% bracket, given the increase in yields and the NIIT.

Review asset location. 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.

Beware of investment-income spikes. In the example above, Dan owed $1,140 of NIIT because he sold a large holding all at once. If he had spread the sale over two years, he might not have owed the surtax.

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