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Ken Berry, JD • Feb. 13, 2014

The specter of the dreaded new surtax on "net investment income" (NII) has turned into reality. For the first time ever, some upper-income taxpayers will have to pay the 3.8% surtax on their 2013 income tax returns. This could be a harrowing experience for some of your clients.

The NII surtax – which was authorized by the Patient Protection and Affordable Care Act of 2010 (aka "Obamacare") — is computed on new Form 8960 (Net Investment Income Tax— Individuals, Estates, and Trusts). The IRS finalized the form just a few scant days before the 2014 tax filing season officially kicked off on January 31.

Here's how it works: The 3.8% surtax applies to the lesser of a taxpayer's NII or the excess modified adjusted gross income (MAGI) above an annual threshold. The threshold is $200,000 for single filers, heads of household and qualifying

- Capital gains from the sale of stocks, bonds and mutual fund;
- Interest and dividends;
- Rent and royalties;
- Gains from investments in passive activities; and
- Net capital gain from the sale of property other than property held in an active trade or business.

Conversely, the following income items are specifically excluded from the definition of NII:

- Wages and self-employment income;
- Distributions from qualified retirement plans and IRAS;
- Taxable Social Security income;
- Active trade or business income;
- Gain on the sale of active interests in partnerships, S corporations or limited liability companies;
- Income from tax-exempt municipal bonds; and
- Capital gain statutorily excluded from tax on the sale of a principal residence.

To arrive at NII, gross investment income is reduced by deductions that are properly allocable to income items. This includes the following:

- Investment interest expenses;
- Investment advisory and brokerage fees;
- Expenses related to rental and royalty income;
- Tax preparation fees;
- Sate and local income taxes; and
- Fiduciary expenses for estates and trusts.

so the lesser of her NII and excess MAGI is zero.

Example 2: John, a single filer, earned $225,000 in wages in 2013 and realized $10,000 in municipal bond income. His MAGI was $225,000. As a result, he doesn't have to pay the surtax. Reason: He has no NII, so the lesser of his NII and excess MAGI is zero.

Example 3: Sally and Jim, joint filers, had a total of $300,00 in wages in 2013 and realized $25,000 in capital gains and dividends. Their MAGI was $325,000. As a result, the couple must pay a surtax of $950 (3.8% of $25,000). Reason: The NII of $25,000 is the lesser of their NII and excess MAGI of $75,000.

Example 4: Rob and Susan, joint filers, had a total of $200,000 of wages in 2013 and realized $50,000 in capital gains and dividends. Their MAGI was $280,000 because Rob also received an IRA distribution of $30,000. As a result, the couple must pay a surtax of $1,140 (3,8% of $30,000). Reason: The excess MAGI of $30,000 is the lesser of their NII of $50,000 and excess MAGI.

If you need assistance on NII tax calculations, there's a wealth of information available at www.irs.gov and numerous other sites online. For quick reference, you might consult the IRS' list of Frequently Asked Questions at www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

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