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More People Are Paying the Net Investment Income Surtax These Days

The number of returns reporting the surtax has more than doubled and revenue from the tax has grown by $38 billion over the past decade.

Sep. 13, 2023

By Joy Taylor, Kiplinger Consumer News Service (TNS)

More people each year pay this pesky tax: The 3.8% surtax on net investment income (NII). The tax, which was enacted as part of Obamacare, applies to single filers with modified adjusted gross incomes (AGIs) above $200,000 and to joint filers with modified AGIs over $250,000. The income threshold is $125,000 for married people filing separately. Here, modified AGI is AGI plus tax-free foreign-earned income.

The tax is due on the smaller of NII, or the excess of modified AGI over the set income thresholds. NII includes dividends, capital gains, taxable interest, annuities, royalties, passive rents and certain income from passive activities. Distributions from 401(k)s, IRAs, pensions, and the like are not investment income. Nor is tax-exempt interest from municipal bonds. Investment expenses reduce the income subject to the surtax. Trusts and estates can also be hit with the surtax if their 2023 AGI exceeds $14,450 and they have undistributed net investment income.

Unlike many of the federal income tax breaks and income phaseout levels, the individual income levels for the 3.8% NII tax aren't indexed to inflation each year. The $125,000, $200,000 and $250,000 modified AGI thresholds have stayed stagnant since the tax first took effect in 2013, despite the high growth in wages, income, and gains from sales of real estate and other investment assets. Partly because of this, the number of 1040 returns reporting the NII surtax has more than doubled over the past decade, from 3 million for 2013 returns to 7 million for 2022 returns. Additionally, revenue from the tax has grown by $38 billion during the same period.

GOP and Democratic lawmakers have proposed changes to the 3.8% tax. Not surprisingly, Republicans want to limit the hit of the NII surtax. For example, a GOP Senate bill proposes to raise the $250,000 modified AGI threshold for joint filers to $400,000, so that it is exactly double that of single filers. That bill would also index the three modified AGI thresholds to inflation each year.

President Biden takes a different approach. He wants to expand the NII tax. First, he would hike the rate to 5% for people with over $400,000 of income. More specifically, the tax would rise by 1.2 percentage points on the lesser of NII or modified AGI over $400,000. For other taxpayers, the rate would stay at 3.8%.

Second, Biden has proposed that the surtax cover more business income. Currently, income from a passive activity is NII and is subject to the 3.8% surtax for taxpayers who don't materially participate in the activity, even if the income is from a business. This rule applies to income from activities engaged in directly and to pass-through income from LLCs, limited partnerships and S corporations. Income from a person's share of business profits from a pass-through entity in which one materially participates is exempt from the 3.8% tax and the 0.9% surtax on earned income of upper-incomers. Biden would impose the NII tax on income derived from pass-through entities in which an individual materially participates. The change would affect joint filers with incomes over $500,000 and $400,000 for singles.

Third, Biden aims to use revenues from the NII tax to shore up Medicare, to stave off the insolvency of Medicare's Hospital Insurance Fund. Believe it or not, money from the NII tax, commonly referred to as a "Medicare surtax," has gone into general revenues for years.

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