NIIT Nits

by William E. Sigler

In theory, the idea of a 3.8 percent tax on net investment income could not be simpler. But, in a tribute to the ability on the part of legislators and regulators to overcomplicate even the simplest concept, we have the 3.8 percent Medicare surtax on net investment income, which became part of the law when the Health Care and Education Reconciliation Act of 2010 added Section 1411 to the Internal Revenue Code (IRC), effective for taxable years beginning after December 31, 2012.

Overview

The net investment income tax (NIIT) applies when modified adjusted gross income exceeds $200,000 for an unmarried taxpayer, $250,000 for a married couple filing jointly, or $125,000 for married couples filing separately. These thresholds are not adjusted for inflation. The amount subject to the NIIT is the lesser of net investment income or the amount by which modified adjusted gross income exceeds the applicable threshold.

Calculating Net Investment Income

Conceptually, net investment income is determined by adding up various kinds of investment income and then subtracting deductions that are allocable to those types of income. However, the details are more complicated. First, investment income generally consists of the sum of the following:

- gains from the disposition of assets that are considered held for investment, such as stocks, bonds, mutual funds shares, investment real estate, capital gain distributions from mutual funds and the taxable portion of gains from selling personal residences;
- gross income from dividends and interest, excluding tax-free interest such as municipal bond interest;
- gross income from rents, royalties and annuities;
- gross income and gains from passive business activities, including gains from the disposition of passive ownership interests in partnerships and S corporations; and
- gross income and gains from the business of trading in financial instruments or commodities (even if the activity is nonpassive).
- The following types of income are exempt from the NIIT:
- wages and self-employment income;
- operating income from nonpassive business activities;
- distributions from tax-favored retirement plans and accounts such as 401(k) plans, pension plans, traditional IRAs and Roth IRAs;
- Social Security benefits; and
- tax-exempt interest, unemployment compensation and alimony.

Gain from selling a principal residence is excluded under Section 121 of the IRC up to $250,000 for an unmarried taxpayer or $500,000 for a married couple filing jointly. To the extent that the gain from selling a principal residence is excluded under Section 121, it is also exempt from the NIIT. However, the excess is considered investment income that is potentially subject to the NIIT. Gain from selling a vacation property is also considered investment income that is potentially subject to the NIIT.

"Guaranteed payments" to partners are payments either for services rendered by the partner to the partnership or for the partnership's use of capital provided by the partner.[1] These payments are referred to as "guaranteed payments" because they must be made even if the partnership has no net income. Guaranteed payments for services are excluded from net investment income. In contrast, guaranteed payments for the use of capital are included in net investment income because they are viewed as interest payments.[2]

An interest in a partnership or S corporation is generally considered to be held for investment. Therefore, gain or loss from a disposition of a partnership or S corporation interest is generally included in the transferring partner or shareholder's net gain for NIIT purposes.[3] However, there is an exception for any part of the interest held in a nonpassive business activity. An example of a partnership or S corporation interest that would be considered to be held in a nonpassive business activity would be a medical or den-

Contents

LACHES

OAKLAND COUNTY BAR ASSOCIATION

1760 S. Telegraph Road, Suite 100
Bloomfield Hills, Michigan 48302-0181
(248) 334-3400 • FAX (248) 334-7757
www.ocba.org

2015-2016 Board of Directors

OCBA Mission Statement

The mission of the **Oakland County Bar Association** *is to serve the professional needs of our members, improve the justice system, and ensure the delivery of quality legal services to the public.*

Articles and letters that appear in LACHES do not necessarily reflect the official position of the Oakland County Bar Association and their publication does not constitute an endorsement of views that may be expressed. Readers are invited to address their own comments and opinions to:

LACHES, Oakland County Bar Association
1760 S. Telegraph Rd., Suite 100, Bloomfield Hills, MI 48302-0181

Publication and editing are at the discretion of the editor.

LACHES (ISSN 010765) is the monthly publication (except July and December) of the Oakland County Bar Association, a Michigan non-profit corporation, 1760 S. Telegraph, Suite 100, Bloomfield Hills, MI 48302-0181. ©2016 Oakland County Bar Association. The price of an annual subscription ($20) is included in member dues. Periodical postage paid at Bloomfield Hills, MI 48304 and additional entry offices. Postmaster: Send address changes in writing to Oakland County Bar Association, 1760 S. Telegraph, Suite 100, Bloomfield Hills, MI 48302-0181.

Issue Highlights

Departments

Advertiser Index