IRA and Pension Distributions and the New Net Investment Income Tax
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Effective as of January 1, 2013, a new 3.8% tax went into effect. The IRS has chosen to call this tax, the Investment Income Tax. In Code section 1411 this tax is called the Unearned Income Medicare Contribution.

This new 3.8% tax applies to certain individuals having net investment income and certain estates and trusts having net investment income. To determine the tax owing, a person will multiply 3.8% time the lesser of:

(1) his or her net investment income (NII) or a person's modified adjusted gross income as reduced by a threshold amount as set forth in the following table:

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

This tax will be owed only if an individual has net investment income and his or her modified adjusted gross income exceeds the applicable threshold amount. Note the discrimination in favor of a single person versus a married person.

The new tax means an individual before taking an IRA distribution will want to determine if he or she will have to pay the 3.8% tax on account of such distribution. For most people and situations, a person will not owe the 3.8% tax on his or her IRA or pension distribution, but in some situations the tax would be owed.

There will be times when a person's IRA distribution will mean the individual will have to pay the 3.8% tax on the IRA distribution. Example. David has wage income of $160,000, he withdraws $10,000 from his traditional IRA and he has dividend income of $40,000. David's tax filing status is single. David's tax is equal to 3.8% times the lesser of his dividend income of $40,000 or the amount of his MAGI income in excess of $200,000 or $10,000. His tax is $380. He would not have owed any NIIT if he had not withdrawn the $10,000 as this distribution put his MAGI above his $200,000 threshold level.

There will also be times when a person's IRA distribution will NOT mean the individual will have to pay the 3.8% tax on the IRA distribution. Example. David has wage income of $120,000, he withdraws $25,000 from his traditional IRA and he has dividend income of $40,000, David's tax filing status is single. Since his MAGI, including the IRA distribution of $25,000, is $185,000 and is less than his threshold of $200,000, the 3.8% net investment income tax is not owed.

There will also be times when a person will take an IRA distribution and he or she will be required to pay the 3.8% tax, but the amount owed does not increase because of such IRA distribution. Example. Paula has wage income of $200,000, she withdraws $40,000 from her traditional IRA and she has dividend income of $60,000. Paula's tax filing status is single. Her MAGI of $300,000 exceeds her threshold level of $200,000. Thus, she owes the 3.8% tax on the $60,000 of net investment income or $2,280 and not on the amount in excess of $200,00. She would have owed this $2,280 even if she not withdrawn $40,000 from her traditional IRA.

What types of income are defined to be non-investment income?
Distributions from IRAs, pension plans, 401(k) plans, tax sheltered annuities, etc. are not investment income. Social security benefits are not investment income.

Wages and income or profits from a nonpassive business including self-employment income are not investment income. Unemployment compensation and workers compensation are not net investment income.

What types of income are net investment income and so they might be subject to the 3.8% tax? Investment income includes interest, dividends, gains from the sale of stocks, bonds, mutual funds, capital gain distributions from mutual funds, certain sales related to real estate, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, business income arising from certain passive activities, and the sale of an interest in a partnership and S corporations by an individual who had a passive interest. Such investment income is reduced by certain expenses properly allocable to the income. And any income or gain excluded from gross income for regular income tax purposes is also excluded from a person net investment income (*e.g. $250,000 exclusion for sale of primary residence*).

A person will need to take into account taxes owed on account of the net investment income tax in complying with the estimated tax payment rules.

This net investment income tax also applies to certain trusts and estates. It does not apply to corporations and other “active” businesses. It does not apply to trusts associated with IRAs or pension plans.

This new 3.8% Medicare tax (*the net investment tax*) is different from the new 9/10ths of 1 percent Additional Medicare tax which also went into effect on January 1, 2013. An individual is liable for the additional Medicare Tax if the individual's wages, compensation, or self-employment income (*together with that of his or her spouse if filing a joint return*) exceed the threshold amount for the individual's filing status:

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000