**8565. How does gain on the sale of a taxpayer’s principal residence impact the determination of whether the taxpayer is subject to the investment income tax? Also, is any or all of the gain subject to net investment income tax?**

The sale of a taxpayer’s principal residence is potentially includible in net investment income as net gain from the sale of property.[[1]](#footnote-1) However, for income tax purposes, a single taxpayer excludes the first $250,000 of capital gain realized from the sale of a principal residence from gross income ($500,000 for a married couple filing jointly).[[2]](#footnote-2) Since only amounts included in gross income for regular income tax purposes are included in net investment income, the same amount of gain excluded from gross income is similarly excluded from net investment income.[[3]](#footnote-3) Consequently, the portion of the gain from the sale of a principal residence that is included in gross income is also included in net investment income.[[4]](#footnote-4)

*Example:* In 2000, Dave and Janice purchased a principal residence for $100,000. In 2014, they sell their residence for $700,000 realizing a total gain of $600,000. Pursuant to IRC Section 121, $500,000 of the gain is excluded from gross income and from net investment income. However, $100,000 of the gain (the amount exceeding the $500,000 exclusion) is includible in gross income and in net investment income. In addition, Dave and Janice have dividend and interest income of $200,000. Their AGI is $425,000.

Applying the formula (see Q 8559), the 3.8% net investment tax is imposed on the lesser of:

1. Net investment income of $200,000 (interest and dividends) plus $100,000 (taxable gain on sale of principal residence), a total of $300,000; or
2. The excess of (i) AGI of $425,000 over (ii) the applicable threshold amount of $250,000 (married couple filing jointly), or $175,000.

As illustrated in this example, the taxpayers’ net investment income includes the interest and dividend income of $200,000 plus only $100,000 of the $600,000 gain from the sale of their principal residence. The excluded gain of $500,000 pursuant to IRC Section 121 does not factor into the computation. In other words, the amount of gain included in gross income is also the amount of gain treated as net investment income. Thus, because the excess of AGI over the applicable threshold amount ($175.000) is less than the taxpayers’ net investment income ($300,000), the 3.8% tax is imposed on the lesser amount.

1. IRC Sec. 1411(c)(1)(A)(iii). It is treated as investment income because it is not property held in a trade or business in which the taxpayer materially participates. [↑](#footnote-ref-1)
2. . IRC Sec. 121(a). [↑](#footnote-ref-2)
3. . Treas. Reg. §1.1411-1(d)(4)(i).. [↑](#footnote-ref-3)
4. . IRC Section 1411(c)(1)(A)(iii). [↑](#footnote-ref-4)