**8568. How does the investment income tax effectively increase the tax rate for capital gains and dividends?**

The 3.8% net investment income tax is a surtax, which means it is imposed independently on net investment income that is also subject to any other applicable income tax rate. To this point, the capital gains and dividend tax rate for taxpayers in the 39.6% tax bracket is 20%. However, if the taxpayer is also subject to the net investment income tax, there is an additional 3.8% tax imposed on those same capital gains and dividends. Thus, adding the two tax rates together, the overall effective tax rate for capital gain and dividends for those taxpayers is 23.8% (20% plus 3.8%).

For taxpayers who are not in the 39.6% tax bracket, the capital gains and dividend tax rate is only 15%. However, it is possible that such taxpayers with modified adjusted gross income that exceeds the threshold levels for the net investment income tax (see Q 8561) may also be subject to the net investment income tax. Adding the 15% regular income tax capital gain and dividend rate to the 3.8% net investment income tax rate, the effective rate of such taxpayers would be 18.8% (15% plus 3.8%).

**8570.02 Can federal income tax credits be used to offset net investment income tax liability?**

Although Federal income tax credits set forth in Subtitle A of the IRC can offset any tax liability, the final regulations state that income tax credits are allowed only against regular income tax (Chapter 1 of Subtitle A) and may not reduce net investment income tax.[[1]](#footnote-1) Examples of this type of tax credit include the foreign income tax credit and the general business tax credit.[[2]](#footnote-2)

The denial of tax credits as an offset of the net investment income tax is reflected by the sequence of reporting tax and tax credits on Form 1040. To this point, regular income tax is reported on line 46 of Form 1040. All tax credits reducing that regular income tax are taken on the following lines 47 – 53. Beginning on line 56, the “other taxes” including the net investment income tax (reported on line 60) are reported. So logistically, all tax credits that reduce regular income tax are taken *before* the entry for the net investment income tax. Moreover, none of those credits are refundable credits (meaning the credits can only reduce the regular tax to zero and not generate a refundable overpayment). Thus, they are of no consequence with regard to the net investment income tax reported on line 60.

**8570.03 What form is used to report net investment income tax?**

As mentioned above, net investment income tax is reported on line 60 of Form 1040. On Form 8960 (attached to Form 1040), the taxpayer computes the tax. In addition to reporting all the taxpayer’s net investment income, amounts reported on Form 8814 (Parents’ Election to Report Child’s Interest and Dividends) are also included.

**Planning Point:** Similar to regular income tax or self-employment tax, individuals who expect to be liable for the net investment income tax may either make estimated tax payments or request their employer to withhold additional amounts to avoid being subject to penalties for underpayment of taxes.[[3]](#footnote-3)

1. Treas. Reg. §1.1411-1(e). [↑](#footnote-ref-1)
2. See IRC Secs. 27, 901, 38. [↑](#footnote-ref-2)
3. IRS Q&A on the Net Investment Income Tax, available at: <http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs> (last accessed April 25, 2014). [↑](#footnote-ref-3)