



Watch out for the growing reach of the additional 3.8% tax on investment income

Strong portfolio performance can bring an unwelcome surprise: an additional 3.8% federal tax. The income thresholds for the net investment income tax (NIIT) aren't annually adjusted for inflation and haven't changed since the tax took effect in 2013. So the NIIT is hitting more taxpayers. If your income is near or above the applicable threshold, year-end planning may help reduce its impact.

When you'll owe the NIIT

The NIIT applies to some or all net investment income once a taxpayer's modified adjusted gross income (MAGI) exceeds certain levels. Net investment income generally includes taxable gains from stocks, bonds, mutual funds and investment real estate, as well as interest, dividends, nonqualified annuity income, royalties and rents. It also can include income from a passive trade or business and from a business that trades financial instruments or commodities.

You'll generally owe the NIIT if you have net investment income and your MAGI exceeds:

- \$200,000 if you're a single or head-of-household filer,
- \$250,000 if you're married filing jointly, or
- \$125,000 if you're married filing separately.

The amount subject to the NIIT is the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold.

Many types of income *aren't* included in net investment income. Examples include tax-exempt interest, the excluded portion of a gain from the sale of your primary home, qualified retirement plan distributions, Social Security benefits, wages and self-employment income. However, taxable retirement plan distributions, wages and self-employment income can increase your MAGI and cause some or all of your net investment income to become subject to the NIIT.

Planning may therefore focus on managing your net investment income, your MAGI or both.

Adjust your investment mix

If your income is high enough to trigger the NIIT, shifting some income-producing investments to tax-exempt municipal bonds could reduce your exposure. Interest from qualifying tax-exempt municipal bonds generally isn't included in MAGI or net investment income. Before making a change, consider the bonds' risks and after-tax return as well as your broader investment objectives.

Qualified-dividend-paying stocks are taxed at the same rates as long-term capital gains: The maximum rate is 20%, but the rate becomes 23.8% with the NIIT. Generally, however, dividends are taxed in the year they're paid, and you can't control when they're paid. Quarterly dividend payments are common.

As a result, you may want to consider rebalancing your investment portfolio to emphasize growth stocks over dividend-paying stocks. Although the capital gain from these investments will be included in net investment income and subject to capital gains tax and potentially the NIIT, this generally doesn't happen until you recognize the gain by selling the stock — so you can control the timing. Also, recognized capital losses can offset capital gains. Investment and diversification considerations should drive any decision to rebalance, however.

Leverage retirement accounts

Tax-advantaged retirement accounts offer both opportunities and risks when it comes to the NIIT.

One opportunity relates to annual contributions. Deductible or pretax contributions to a tax-deferred retirement plan reduce current MAGI. So maximizing your contributions may help keep you below the NIIT threshold or reduce the amount of your income that's subject to the NIIT, depending on your circumstances. Small business owners may have particular flexibility to establish or make large 2026 contributions to retirement plans — possibly even after December 31, 2026.

Retirement plan distributions come with both risks and opportunities. They generally aren't included in net investment income, but taxable distributions can increase MAGI and trigger the NIIT on other income.

Your ability to control the timing of retirement plan distributions provides an opportunity. Consider the potential NIIT impact when timing discretionary distributions (or Roth IRA conversions, which also increase MAGI).

If you're subject to annual required minimum distributions (RMDs), you must take your annual RMD by the deadline or face a penalty on the amount you should have withdrawn but didn't. But if you're charitably inclined, a qualified charitable distribution (QCD) directly from your IRA to charity can satisfy your RMD while excluding the distributed amount from your MAGI.

Review your options

Other year-end strategies that may reduce or eliminate NIIT liability include harvesting capital losses, timing investment gains, donating certain appreciated investments and reviewing passive activities or rental income. The NIIT consequences of any move will depend on both your net investment income and your MAGI. We can help you estimate your potential NIIT and evaluate possible strategies before year end.