

## #19: Choice of Filing Status to Avoid the 3.8% NIIT

Married individuals have a choice between filing jointly or filing separately. The choice they make could make a significant difference in the amount of net investment income tax (NIIT) they pay.

### Background

Before explaining the potential planning opportunity, it is important to review how the 3.8% NIIT on unearned income and the 0.9% Additional Medicare Tax on earned income are calculated. The amount subject to the 3.8% NIIT on unearned income is the lesser of (1) net investment income (NII), or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount (ATA). NII generally includes gross income from interest, dividends, annuities, royalties, a trade or business that is a passive activity with respect to the taxpayer and gain from the sale of property held in a passive business. Some of the items of income that are specifically excluded are distributions from qualified retirement plans, wages and salaries and self-employment income. The ATA for married taxpayers filing jointly is \$250,000 and the ATA for married taxpayers filing separately is \$125,000.

An individual is liable for the 0.9% Additional Medicare Tax to the extent that the individual's wages, compensation, and self-employment income (plus such income of the individual's spouse if a joint return is filed) exceeds the threshold amount for the individual's filing status. These threshold amounts are the same as those for the 3.8% NIIT.

*Example 1.* Warren is a single taxpayer with the following income in 2023:

Salary Income	\$180,000
Self-Employment Income	\$30,000
Dividends	\$10,000
Interest	\$15,000

The amount subject to the NIIT is the lesser of NII (\$25,000) or MAGI - ATA (\$235,000 - \$200,000). Thus, \$25,000 is subject to the NII and the tax payable is \$950 (.038 x \$25,000). The amount subject to the 0.9% Additional Medicare Tax is \$10,000 (\$210,000 - \$200,000) and the tax payable is \$90 (.009 x \$10,000).

### Choice of Filing Status

On the surface it might appear that it should not make any difference whether married taxpayers file jointly or separately because the ATA is exactly double for joint filers. A closer analysis reveals, however, that filing jointly is sometimes better and filing separately is sometimes better, depending on the facts of the case.

If one spouse has most of the NII and the other spouse has most of the non-NII, filing separate returns may save significant amounts on the 3.8% NIIT.

**Example 2.** Ted and Kelly are married taxpayers. Ted has \$450,000 of salary income and no NII. Kelly has \$100,000 of NII from interest and dividends and no other income. First assume that they file a joint return. The amount subject to the NIIT will be the lesser of NII (\$100,000) or MAGI - ATA (\$550,000 - \$250,000 = \$300,000). Thus, if they file jointly \$100,000 will be subject to the NIIT and the tax payable will be \$3,800 (.038 x \$100,000).

Now assume the same facts, except that Ted and Kelly file separate returns. Although Ted has MAGI well above the ATA of \$125,000 for a married taxpayer filing separately, he has no income subject to the 3.8% NIIT because he has no NII. Although Kelly has substantial NII, she is not subject to the NIIT either because her MAGI is below her ATA. Thus, the couple saves \$3,800 of NIIT by filing separately.

It is also possible for NIIT to be payable if spouses file separate returns but not payable if they file jointly. The added \$125,000 of ATA for a joint return could cover NII that would have been subject to the NIIT on a separate return.

**Example 3.** John and Amanda are married taxpayers. John has \$50,000 of salary income and no NII. Amanda has \$100,000 of salary income and \$100,000 of NII. If they file separate returns, John will not be subject to the 3.8% NIIT. Amanda, however, will be subject to the NIIT on the lesser of NII (\$100,000) or MAGI - ATA (\$200,000 - \$125,000). Thus, \$75,000 of her income will be subject to the NIIT and she will pay \$2,850. If John and Amanda file a joint return, no NIIT will be payable. Their NII will be \$100,000, but their MAGI will be only \$250,000—not above the ATA of \$250,000 for married taxpayers filing jointly. This means that by filing jointly they can save \$2,850 in NIIT.

### **Caveat**

In determining which filing status is better for NIIT purposes, the 0.9% Additional Medicare Tax must also be taken into account.

**Example 4.** George and Martha are married taxpayers. George has \$250,000 of salary income and no NII. Martha has \$25,000 of NII and no other income. If George and Martha file separate returns, neither of them will be subject to the 3.8% NIIT because George has no NII and Martha's MAGI is below her ATA of \$125,000. If they file jointly, they will be subject to the 3.8% NIIT on the lesser of NII (\$25,000) or MAGI - ATA (\$275,000 - \$250,000). Thus, \$25,000 will be subject to the 3.8% NIIT and they will pay \$950 in tax (.038 x \$25,000). Thus, they will save \$950 on the 3.8% NIIT by filing separately.

However, this is not the end of the analysis. What about the 0.9% Additional Medicare Tax on earned income? If George and Martha file jointly, they will have total earned income of \$250,000. Because this is not above their ATA of \$250,000 they will not be subject to the 0.9% tax. If they file separately, Martha will not be subject to the 0.9% tax, but it will apply to \$125,000 of George's income (\$250,000

earned income - \$125,000 ATA). The tax payable on this earned income would be \$1,125 (.009 x \$125,000). If we combine the added 0.9% tax (+ \$1,125) with the savings on the 3.8% NIIT (- \$950), by filing separately it actually increases the tax paid by \$175 (\$1,125 - \$950).<sup>67</sup>

Note that the reduction in the 0.9% Additional Medicare Tax is due to the fact that the ATA for married taxpayers filing jointly is higher than the ATA for a married taxpayer filing separately. Because the maximum additional ATA for a joint return is \$125,000, the maximum reduction in the 0.9% Additional Medicare Tax is  $\$125,000 \times .009 = \$1,125$  by filing jointly as opposed to separately. If the NIIT savings from filing separately exceeds this amount, separate filing will always produce a net tax reduction when both taxes are taken into account.

Furthermore, when considering which filing status is best for NIIT purposes, the effects of choosing one filing status over another for other tax purposes must also be considered. For example, the regular income tax brackets for taxpayers filing separately are much more condensed than for taxpayers filing jointly. Thus, although a taxpayer may save on the NIIT by filing separately, they may end up paying much more in regular income taxes because of that filing status.

## Disclosures

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<sup>67</sup> See Kaplan, Richard L., *Rethinking Medicare's Payroll Tax After Health Care Reform*, TAXES, August 2011.