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Donors with modified adjusted gross income (MAGI) above an applicable threshold pay a 3.8% surtax called the Net Investment Income Tax or NIIT. This surtax is imposed on the lesser of (1) net investment income or (2) the amount by which modified adjusted gross income (MAGI) exceeds the applicable threshold. It is imposed on top of the taxpayer's regular income tax. The tax took effect on January 1, 2013.

There are three categories of net investment income subject to the surtax. Category 1 includes gross income from interest, dividends, annuities, royalties, and rents not earned in a qualifying trade or business. Category 3 includes capital gains (short-term or long-term) on the sale or other disposition of assets not held in a qualifying trade or business. The type of income planned gifts ordinarily produce falls into Category 1 or 3.

The surtax crosses regular tax brackets. For example, a couple who are married filing jointly with \$100,000 in wage income and \$200,000 of long-term gain on the sale of appreciated stock will be in the 25% tax bracket, with capital gains taxed at a lower rate of 15% (rising to 20% in 2013). However, since their MAGI is \$300,000, they are subject to NIIT on \$50,000, which is the lesser of \$200,000 in net investment income and \$50,000 excess MAGI over the threshold (\$300,000 - \$250,000). This effectively raises their marginal capital gains tax rate from 15% to 18.8% to 23.8% since the 15% rate rose back up to 20% in 2013. That makes giving appreciated property to charity more attractive.

Only properly allocable deductions paid or incurred to produce the income can be deducted for purposes of the surtax. That does not include the charitable deduction.

For upper-income taxpayers, income from planned gifts is subject to the 3.8% Medicare surtax as described below.

Gift annuities

The ordinary income portion of the annuity is surtaxed as Category 1. The capital gain portion is subject to surtax as Category 3 but can be spread over life expectancy under the same rules as for the regular income tax. This is the

treatment afforded installment sales, and unfortunately the IRS guidance does not directly address gift annuities funded with appreciated property, but it seems to us the same principle applies. The tax-free portion is not subject to surtax.

Charitable remainder trusts

CRTs are exempt but the CRT beneficiary is surtaxed. The charitable remainder trust itself is exempt from the surtax. However, the beneficiary is surtaxed on the lesser of (1) the total amount of distributions for the year or (2) the current and accumulated net investment income for the CRT, with the accumulation starting after December 31, 2012. This means that the amount subject to surtax is not necessarily the same as the amount subject to the regular income tax. That's because the CRT tiers of income approach takes into account income for all years of the trust, not just years after December 31, 2012. The beneficiary is never surtaxed on more than their total distribution for the year, even if the CRT earns more than was distributed that year, such as a big capital gain on the sale of the donated property.

Pooled income funds

PIF income is surtaxed. The beneficiary will be surtaxed on taxable distributions from a pooled income fund. The PIF itself is not exempt, and as a trust it may be surtaxed on short-term gains not distributed by the trust, if the trust's undistributed net investment income exceeds \$12,150 for 2014. Long-term gains retained by the pooled income fund and set aside for charity are excludable, as they are for the regular income tax.

Non-grantor and testamentary charitable lead trusts

Non-grantor and testamentary CLTs are surtaxed on undistributed net investment income. Amounts distributed by a charitable lead trust to meet the charitable payout would escape the surtax. However, any excess would be subject to surtax at the trust level. The surtax threshold for trusts is the amount of income where the highest income tax bracket begins, only \$12,150 for 2014. That could hit capital gains realized from portfolio rebalancing, as the capital gains tax does already, if those gains plus other income exceed what was distributed to charity.

Grantor charitable lead trusts

Grantor CLTs are surtaxed on the donor. Grantor charitable lead trusts are exempt at the trust level but any net investment income passes through to the donor's tax return, with no deduction for the charitable payout, in the same way as there is already no charitable deduction for the regular income tax imposed on the donor for grantor CLT income and capital gains.

Retained life estates

RLEs are surtaxed on rental income. Typically, a retained life estate is for a home in which the donor continues to live and for which the donor receives no income, so there would be no surtax. But, in the rare case the home or farm is rented, that rent would be subject to surtax, unless the income comes from an active trade or business such as farming.

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