The Certainty of Taxes
The Net Investment Income Tax

What is the 3.8% Net Investment Income Tax?

One of the many provisions of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 is the Net Investment Income Tax (NIIT). This new tax became effective in January 2013, and many high net worth taxpayers will feel the effects as they prepare their 2013 income taxes. It is also referred to as "Unearned Income Medicare Contribution Surtax", "Medicare Surtax" or "ACA Surtax".

The NIIT imposes a 3.8% surtax on (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over a certain threshold amount, *whichever is less.* Tax-exempt entities, such as charities, charitable remainder trusts and traditional and Roth IRAs are not subject to this tax.

Who is subject to the Net Investment Income Tax?

For individuals, the NIIT applies to US citizens, resident aliens and dual-status individuals with respect to the portion of the year during which they are a US resident. The tax does not apply to non-resident aliens unless they elect to be treated as a resident of the US for tax purposes, or dual-resident individuals determined to be non-residents of the US.

The tax also applies to estates and trusts if they have undistributed net investment income and if MAGI exceeds the dollar amount at which the highest tax bracket begins for the tax year, which in 2013 was $11,950. There are some estates and trusts that are not subject to the NIIT. For more information, consult IRS publication "Questions and Answers on the Net Investment Income Tax" at www.irs.gov or consult your professional tax advisor.

What individual income levels trigger the Net Investment Income Tax?

The surtax is applied at the following thresholds after calculating MAGI:

- Married filing jointly or Qualifying Widow(er) $250,000
- Single or Head of Household $200,000
- Married filing separately $125,000

These thresholds for individuals are not indexed for inflation and will stay the same year to year unless Congress specifically changes them through new legislation.

What is included under net investment income?

The tax is applied to three categories of gross income:

1. Gross income from taxable interest, dividends, annuities, royalties and rents.
2. Gross income from a trade or business (1) that is a passive activity; one in which the taxpayer does not materially participate, or (2) a business trading in financial instruments or commodities.
3. Net gain, to the extent taken into account in computing taxable income, which would include capital gains.

How is the Net Investment Income Tax calculated?

The 3.8% surtax is in addition to any other taxes paid. The calculation is a two-step process:

1. Calculate MAGI and the amount (if any) by which it exceeds the appropriate threshold.
2. Determine the total net investment income earned for the year.

The tax is applied to the lesser of the two figures.

To illustrate, a single filer with a MAGI of $230,000, would be $30,000 over the threshold. If the net investment income portion of MAGI, from the three categories listed above, is $15,000; the NIIT would be based on investment income since it is less than $30,000. The NIIT liability would therefore be $570 (3.8% of $15,000) in addition to the regular income tax .

Let's consider an illustration for a joint return. A couple filing jointly with a MAGI of $290,000 would be $40,000 over the applicable threshold of $250,000. If the net investment income portion of that MAGI is $50,000 , the NIIT would be based on MAGI in excess of the threshold amount, $40,000, since it is less than the $50,000 net investment income. In this case the NIIT liability would be $1,520 (3.8% of $40,000).

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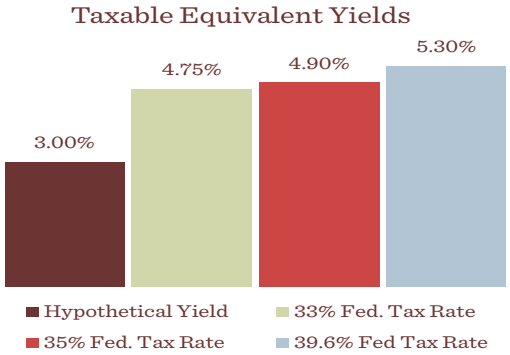
Is tax-exempt municipal bond interest considered net investment income?

The interest income from a municipal bond is generally exempt from federal and state income taxes, and is not included in the calculation of MAGI. Tax-exempt interest on a municipal bond is not considered investment income for the purpose of calculating NIIT, so it is exempt from the 3.8% surtax.

The tax-exempt status, and the exclusion from the NIIT, may make income from municipal bonds and municipal bond funds an attractive investment for certain tax payers.

The chart to the right illustrates what a taxable investment, with NIIT applied, would need to yield to match a 3% tax-exempt yield at the highest federal tax brackets. This chart does not include state income tax.



This is a hypothetical illustration and does not represent an actual investment

Where can I find more information on the Net Investment Income Tax?

For more information on the NIIT consult the Internal Revenue Service website at www.irs.gov, the American Institute of CPA's at www.aicpa.org, or your professional tax advisor.

Aquila Group of Funds

The Aquila Group of Funds offers seven state-specific municipal bond funds which invest in municipal obligations of investment-grade quality, seeking to provide a high level of current income exempt from state and regular federal income taxes, while preserving capital. For more information on the Aquila Group of Funds, visit www.aquilafunds.com.

Mutual fund investing involves risk; loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in credit quality of the issuer, borrower, counterparty, or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. Fund performance could be more volatile than that of funds with greater geographic diversification.

For certain investors, some dividends may be subject to federal and state taxes, including the Alternative Minimum Tax. Consult your professional tax advisor.

The Net Investment Income Tax (NIIT) is a 3.8% tax established by the Patient Protection and Affordable Care Act (PPACA) that applies to the lesser of (1) net investment income or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) in excess of an applicable threshold amount. For more information, please consult your professional tax advisor.

Before investing in a fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the fund prospectus. The prospectus is available from your financial advisor, when you call 800-437-1020, or visit www.aquilafunds.com.

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