Stay a Step Ahead of the New Medicare Surtax

Morningstar Research | Christine Benz

As usual, the economic news is a swirling mess of situations that we investors have no power to predict, let alone influence: Europe's financial crisis, slowing global growth, and U.S. presidential candidates sparring over the best way to manage a lackluster economy.

Yet hiding in plain sight—and receiving much less coverage—are a handful of issues over which investors can actually exert some level of control. Managing your portfolio for maximum tax efficiency, while not as sexy as thinking about Spain's next move or the possible outcome of the November election, is an easy way to pocket a bit (or maybe a lot) of extra return.

One specific item that higher-income folks should have on their radar right now is the new Medicare surtax that's set to go into effect in 2013. (The tax also affects trusts and estates, but for this article, I'll focus on how the tax will affect individuals.) The tax will be imposed on the lesser of an individual's net investment income for the year or adjusted gross income in excess of $200,000 for single filers and $250,000 for married taxpayers filing jointly. (Note that investment income is included in adjusted gross income.)

That means that a couple with $275,000 in adjusted gross income and net investment income of $15,000 in 2013 would owe the 3.8% tax on the $15,000 in investment income. (That amount is less than the $25,000 by which their adjusted gross income exceeds the $250,000 threshold.) By contrast, a couple with $220,000 in adjusted gross income and $15,000 in investment income wouldn't owe the surtax at all because their adjusted gross income doesn't exceed the $250,000 threshold; that amount ($0) is smaller than their investment income. Meanwhile, a couple with a $300,000 adjusted gross income, $150,000 of which consists of investment income, would owe the surtax on $50,000, the amount by which their adjusted gross income exceeds the $250,000 threshold and is lower than their investment income.

As you can see from the examples above, the tax will have the greatest impact on people with high incomes composed largely of investment income. Even if you have a high adjusted gross income, you're not likely to owe the surtax unless a big share of that income is coming from investments. Even if most of your income comes from investments, you're not going to owe the surtax unless you have an adjusted gross income that's high in absolute terms.

What Counts as Net Investment Income?

Adjusted gross income is fairly straightforward, but what counts as net investment income isn't. As you might expect, net investment income encompasses stock dividends and interest from cash and bonds; it also includes short- and long-term capital gains, the taxable portion of annuity income, royalties, and rents. In addition, net investment income includes trading of financial instruments and commodities and income from passive activities (earnings from a business in which you have limited involvement).

That's a big list, but there are some notable exceptions. Municipal-bond income does not count as net investment income; the same goes for distributions from IRAs or other qualified retirement plans and pension and Social Security income. Capital gains from the sale of a principal residence don't count either, assuming the gains don't exceed $250,000 for individuals and $500,000 for couples and meet the other requirements to qualify for the Section 121 exclusion. (That's right—a widely distributed email stating that all home-sale proceeds would be subject to the tax is patently false.) Nor does the surtax apply to payouts from tax-deferred nonqualified annuities or the proceeds from the sale of an active interest in a business that's structured as a partnership or S corporation.

Those exceptions, as well as the fact that the surtax isn't scheduled to go into effect until 2013, create a few potential opportunities for alert investors aiming to limit the surtax's effect. Of course, as always, it's a mistake to rearrange your investment portfolio simply because of tax considerations. If you're mulling action to blunt the impact of this or any other tax, it's worth your while to check with a tax or investment advisor beforehand.

Those disclaimers aside, investors who expect to be hit by the new surtax might consider a few steps to reduce its impact, including the following.

Take a look at munis (again): Muni-bond income has a double benefit when it comes to avoiding the surtax. Not only does it not count toward your adjusted gross income, but it's also a rare type of investment income that's not subject to the new surtax. In addition, it's also possible that the surtax could stoke underlying demand for munis. At the same time, if you're looking at munis to help save on taxes, be sure to mind the fact that municipal bonds issued to fund private activities, such as sports venues, are subject to the alternative minimum tax, even though they skirt other types of taxes. Fidelity's muni funds grab the highest number of Gold Morningstar Analyst Ratings.

Maximize contributions to tax-advantaged vehicles, mind asset location: Maximizing contributions to tax-advantaged vehicles, such as IRAs and 401(k)s, makes good sense no matter what, and the surtax provides yet another reason to do so. Not only are distributions from IRAs and 401(k)s exempt from the new tax, but reinvested income from stocks and bonds held within the confines of these wrappers doesn't count as net investment income. That, plus the fact that income, dividend, and capital gains tax rates are set to increase in 2013, underscores the importance of paying attention to what types of assets you hold in which types of accounts. Munis, individual stocks, low-turnover stock funds, and broad stock market index trackers are good bets for taxable accounts, whereas investments with a heavy tax burden should generally be stashed within tax-advantaged accounts.

Investigate Roth anything: Even though income from traditional and Roth 401(k)s and IRAs is safe from the new surtax, Roth IRA and 401(k) withdrawals are even more bulletproof. Distributions from traditional 401(k)s and IRAs have the potential to push up a taxpayer's adjusted gross income above the thresholds for the surtax, which in turn could increase one's vulnerability to the new tax. Roth IRA distributions, by contrast, don't contribute to adjusted gross income.

That's another reason to consider making new contributions to Roth vehicles (or fund a backdoor Roth IRA) rather than traditional IRAs and 401(k)s, as well as converting traditional IRA assets to Roth. But time is of the essence for conversions: If you wait until 2013, the money from the conversion will increase your adjusted gross income, which in turn could increase the likelihood you'll owe the surtax. In addition, income tax rates are set to go up in 2013, though Congress may take action to reverse them, so you're better off paying the conversion-related taxes at 2012's lower rates instead. In the case of conversions, check with a financial or tax advisor to make sure you're thinking through all of the variables and understand the taxes you'll owe upon conversion.

Sell appreciated securities and property in 2012: Here's another area where you absolutely don't want to put the tax cart before the horse; investment and other considerations should be the main driver of what you do. But if you had it in your head to sell an asset on which you'll owe capital gains, ranging from a vacation home to a long-held stock, doing so in 2012 might be a better idea than waiting until 2013. Capital gains rates are set to go up next year, barring Congressional action, and selling in 2013 would also push up the amount of investment income that's subject to the new surtax. M