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10 Investment Strategies to Cope with the New Medicare Taxes

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The 3.8% Net Investment Income Tax

This surtax is applied against the lesser of your net investment income ***or*** modified adjusted gross income (MAGI) in excess of the threshold amounts. (The modified adjusted gross income (MAGI) is found by taking your adjusted gross income and adding back certain items such as student-loan deductions, IRA-contribution deductions, and deductions for higher-education costs.)

The threshold for single and head of household filers is $200,000. For married couples filing jointly it is $250,000 and married filing separately $125,000.

Many high income earners with incomes over the thresholds will have a difficult time avoiding the 3.8% surtax on their investment earnings. These earnings could come from taxable interest, dividends, rent, taxable annuities, net capital gains, and income from businesses you own but don't actively manage.

The Additional 0.9% Medicare Tax

If you are an employer, you will be required to withhold an additional 0.9% in taxes on income above $200,000 in a calendar year to help pay for Medicare. Fortunately, you won't have to match it. However, if you file as a self-employed individual, you will not be able to allow a deduction for any portion of the additional 0.9% tax.

Some couples are going to be in for a big surprise. Suppose they each make $150,000, which is below the threshold of $200,000. So, they would have no withholding for this 0.9% tax. But when it comes time for them to file their 2013 income taxes, they will be liable for the additional Medicare tax on $50,000, which exceeded the threshold of $250,000 for a married couple.

10 Basic Strategies

Your basic strategy is to get your investment income and/or your MAGI below those thresholds. Here are a few suggestions to help you do this.

1. Increase contributions to tax-deferred retirement plans. This has the effect of lowering your MAGI, plus assets within tax-deferred plans do not generate any taxable investment income. The amount you can contribute has risen to $17,500 if you are under age 50, and to $23,000 for those over age 50. If you have your own profit sharing plan, or you are the sponsor of one, you could potentially defer either $51,000 or $55,500 total, depending upon your age.

SIMPLE plans aren't quite as generous.

2. Beware of high turnover mutual funds, such as those with "long-short," market timing, and "go-anywhere" strategies. They might smooth out the bumps in a volatile market, but end up costing you more in taxes. A lower turnover rate in this new tax environment may be better.

3. For those over age 701/2 subject to minimum distributions (RMDs) consider a direct charitable rollover to one or more of your favorite charities. You can rollover any amount up to $100,000, even though your RMD might be less. Since this is a direct rollover, the distribution does not increase your MAGI.

4. Harvest your losses by netting them against your gains every year. This seems so basic, but we seldom see that when reviewing account statements of new clients coming in the door. You can always buy that favorite stock or mutual fund back 31 days later.

5. Think about tax-exempt interest from municipal bonds, in lieu of other income-producing securities. However, don't let the tax tail completely wag your portfolio. A higher-yielding corporate bond after paying taxes and the surtax might still result in a higher net return.

6. Think more about growth stocks as opposed to dividend-paying stocks. As a result of the surtax and the fiscal cliff legislation, federal income taxes on dividends for high income tax payers have gone from 15% to 23.8%. A buy and hold strategy on an asset with good potential for capital appreciation won't incur the tax until it is sold.

7. Consider taking withdrawals from your Roth IRA first if you depend upon IRAs for retirement income. Roth withdrawals are non-taxable, thus lowering your MAGI. Sooner or later, you may need to withdraw from your taxable IRA, but a dollar of income that is tax deferred today, is a bigger dollar that gets to grow and compound than one that got taxed.

8. Use college savings accounts. Save for the education of your children and/or grandchildren using the tax-advantaged 592 plans.

9. Consider installment sales. If you are selling real property, installment sales could defer income over several years. This could help keep you under the MAGI threshold or keep your investment income lower.

10. Work closely with your tax professional throughout the year. This is perhaps the most cost-effective suggestion I can make. If you wait until mid-December, it might be too late.

There are a few more strategies that involve the use of trusts and passive business management, but they are beyond the scope of this article. The bottom line is that these new taxes are unavoidable for high income earners. All you can do is control what you can control with proactive planning.