New prescription

Two new taxes went into effect in 2013, as a result of the adoption of health care reform. An additional 0.9% Medicare tax applies to wages in excess of $200,000 ($250,000 for marrieds filing jointly). This applies to the employee only, not to the employer. For the first time, an element of the Social Security tax will not be applied at a flat rate.

Another first: Social Security taxes apply to investment income. For those whose adjusted gross income (AGI) is above $200,000 ($250,000 for marrieds filing jointly, $125,000 for marrieds filing separately), a 3.8% additional tax will apply to investment income above the threshold.

What is taxed, and what is not

"Investment income" includes interest, dividends, rents, royalties and capital gains. Pension income, IRA distributions and municipal bond income will not be hit by the 3.8% tax. The taxable portion of annuity payments will be subject to the tax unless they are part of a company pension plan.

Note that, because the income is keyed to adjusted taxable income, having substantial itemized deductions will not affect this tax—even if a loss is large enough to bring taxable income down to zero! Also, the capital gain on the sale of a personal residence could be taxed if it is larger than the $250,000 exclusion ($500,000 for couples).

Examples

John and Mary (example is fictitious) have pension and Social Security income of $80,000 and investment income of $170,000. They will not owe additional tax, because their total AGI is right at the threshold.

Now assume that the couple takes a $60,000 withdrawal from their IRA. IRA withdrawals are not hit by the 3.8% tax, but they will be added to the couple's AGI. That pushes $60,000 of their investment income into the taxable zone.

Portfolio impact

Higher taxes could make municipal bond income even more. That could push up prices for muni bonds, driving down yields and increasing the spread compared to taxable instruments.

The opposite effect might be seen with dividend-paying stocks. Dividends will be less tax efficient than capital gains. If investors come to value dividends less highly, the prices of such stocks may suffer.

One way to take more control over one's tax exposure is to convert traditional IRAs to Roth IRAs. That will eliminate the need for required minimum distributions from the IRA, which might trigger excess taxes. What's more, distributions from the Roth IRA are potentially tax free, and as such, they would not increase AGI and the taxes on investment income.