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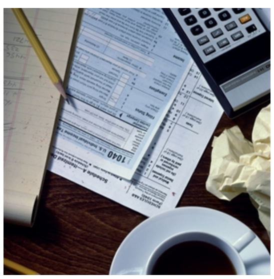
The Investment Tax Landscape: Countdown to 2013



In December 2010, Congress extended the so-called Bush-era tax cuts. However, for investors, the legislation may have been a stay of execution rather than a full pardon. As of January 1, 2013, federal tax rates on income, qualifying dividends, and capital gains (among other provisions) are scheduled to revert to previous levels.

Given recent partisan wrangling, no one can be completely sure about precisely what will happen. Even if all the scheduled changes don't ultimately go into effect, others likely will. In the meantime, as the clock ticks closer to some sort of decision point, it might make sense to review your portfolio and do some "what-if" planning for various scenarios. Taxes obviously are only one factor--and not necessarily the most important one--in decisions about your portfolio; think of this as a chance to fine-tune your planning efforts.

Capital gains

You'll want to pay attention to scheduled changes in tax rates, especially if your income is more than $200,000 a year ($250,000 for you and your spouse, $125,000 if married and filing separately). Absent further action, current tax rates will be replaced by five federal tax brackets rather than six (see table) and the top long-term capital gains rate will go up.

If you're considering selling an asset that has appreciated substantially, determine whether you should do so this year rather than next. Even if some current income tax rates are extended, individuals or households with incomes above the $200,000/$250,000 limits might still face higher rates. If you're above the threshold, you could be hit simultaneously with a higher capital gains rate on the proceeds of your sale and a higher income tax rate.

Don't forget the alternative minimum tax in your calculations. Although the AMT doesn't apply directly to long-term capital gains and qualifying dividends, they're included when calculating your taxable income under the AMT. If realizing a large capital gain indirectly increases your AMT exposure or might push you into the phaseout range for AMT exemptions, that could potentially wipe out any tax savings from selling this year.

If you think an investment will continue to be a sound one but feel you would benefit from selling prior to 2013 to take advantage of current low rates on existing gains, you could sell the investment, and then wait at least 31 days to repurchase it. That would give you a higher cost basis for any subsequent sale, potentially reducing your tax liability at that point. Also, even if you do decide to sell, you don't necessarily need to do so all at once. The tax cuts that produced the current rates have already been extended once, and it could happen again. Repositioning your portfolio gradually could moderate the risk of a single badly timed sale. There also are a variety of strategies for managing concentrated stock positions; get expert help before deciding that selling is your only choice.

Dividends

There's another reason the scheduled tax bracket changes are important. As of 2013, qualifying dividends are scheduled to be taxed as ordinary income, as they were before 2003, rather than at the lower rate for long-term capital gains. The higher your tax bracket and the more you rely on dividends for income, the more you should be aware of the potential impact of that change on you.

However, remember that taxes aren't the only factor you should consider in making a decision. Dividends can still represent a welcome income alternative to interest rates that are expected to remain at rock-bottom levels through mid-2015. And with baby boomers beginning to reach retirement age, interest in any and all sources of ongoing income is unlikely to disappear. As with capital gains, many factors will affect your decision about the role of dividends in your portfolio.

Tax traps with munis

Only the interest paid by muni bonds is tax free; you could owe taxes on any increase in a bond's value when sold. Also, not all munis are tax exempt; the primary example is so-called private-purpose bonds, whose interest is taxable at the federal level unless specifically exempted. And even if it is specifically exempted from regular federal income tax, interest on private-purpose bonds may be included when calculating alternative minimum tax (AMT). Finally, holding tax-exempt securities in a tax-deferred account could mean you're accepting a lower return but getting no additional tax advantage.

Current and New Federal Tax Rates

	2012	**As of January 1, 2013**
Ordinary income	10%, 15%, 25%, 28%, 33%, 35%	15%, 28%, 31%, 36%, 39.6%
Capital gains (generally)	15% maximum; 0% for those in 10% and 15% income tax brackets	20% maximum; 10% for those in 15% income tax bracket
Qualified dividends	Taxed at long-term capital gains rate (15% top rate)	Taxed as ordinary income (39.6% top rate)
Medicare contribution tax on unearned income	N/A	3.8% on net investment income for individuals with MAGI over $200,000 ($250,000 for married couples filing jointly; $125,000 for married individuals filing separately)

Investment income/payroll taxes

There's another factor you may need to be aware of. Beginning in 2013, a new 3.8% Medicare contribution tax will be imposed on some or all of the unearned income of individuals with high modified adjusted gross incomes (see table). Also, the hospital insurance portion of the payroll tax is scheduled to increase by 0.9% for higher-income individuals. However, unless you exceed the specified thresholds, neither provision will affect you.

If you expect to be affected by the new taxes and/or a higher tax bracket, the benefits of tax-free investments might become even more pronounced. Taxable bonds typically pay higher interest rates than municipal bonds, but if you're in a high tax bracket, munis can potentially offer a better after-tax return. As with any investment decision, there are many factors to consider. Local and state governments have come under severe financial pressure, and though the default rate on munis has traditionally been low, a default is always possible. Also, interest rates have been at historic lows since the end of 2008; since bond prices move in the opposite direction from their yields, rising interest rates would not be good news for bond prices.

Good time for a checkup

If you do decide to make adjustments, this year will require a tradeoff in timing them. Postponing action may give you more clarity, but waiting until the last minute could potentially leave you caught in a stampede for the door at year's end, or trying to make decisions during a volatile period. If you decide to sell, make sure you've allowed enough time to accommodate trade settlements and holiday schedules.

Investments in tax-deferred accounts, such as IRAs or 401(k)s, won't be affected by any tax changes until you withdraw the money, so unless you're contemplating the timing of a withdrawal, you may not need to worry much about them. However, if you've been considering a Roth IRA conversion, find out whether you would reduce your tax liability by converting in 2012 rather than later.

Even if 2013 seems unlikely to have much impact on you, this could be a good time for some routine portfolio maintenance. And if you think you might be affected by any of the above situations, it's especially important to get expert help.