Investment Planning in an Uncertain Tax Environment

Three potential tax law changes and how you can prepare for them

By Baird Financial and Estate Planning

Summary

Tax law is much like shifting sand – never entirely solid, and subject to the frequent changes from political or economic winds. Such winds are definitely blowing in Washington today and, to capitalize on or avoid the potentially negative impact of likely changes, investors must be aware of what's going on and be nimble in their reactions.

This paper will identify the potential tax issues investors will most likely face in the near future and offer suggestions on how to address them.

Taxes could be significantly higher next year, and the months remaining in 2012 offer the last chance to prepare. These strategies should be discussed with your Financial Advisor and tax professional now, rather than waiting for clarity that may come too late for you to react.

Taxes Are Already Set to Increase

If the tax cuts enacted in 2001 and 2003 ("the Bush tax cuts") sunset as scheduled after 2012, the reductions many taxpayers have enjoyed for the last decade will end. On the campaign trail, President Obama has repeatedly said he would like to see these cuts extended for families with income below $250,000 and singles below $200,000. For filers above those thresholds, however, his preference is to repeal the cuts and, in some cases, add additional taxes. Presumptive Republican candidate Mitt Romney has said he believes any tax increase now would devastate our delicate economic recovery, and favors extending the Bush-era tax cuts as well as additional cuts for individual tax rates.

Despite the rhetoric, however, the upcoming presidential election may not have as significant an impact as voters hope. Changing tax law is Congress' purview, and the Republican takeover of the House in 2011 ensured a split in Washington that has made passing significant legislation nearly impossible. For example, Congress recently allowed the AMT patch to expire, at least temporarily, creating a stealth tax increase that will impact an estimated 27 million new taxpayers, or nearly one out of every five tax filers.[1]

Death and Taxes

For the Wealthy, the Combination Is far From Certain

Estate tax changes on deck for 2013 may not have a direct impact on investment strategies, but they could influence how assets are titled and emphasize the importance of wealth transfer strategies.

Currently the value of assets that can pass untaxed to a non-spouse beneficiary upon the death of the owner is $5.12 million. This is set to change to $1 million in 2013. Simultaneously, the tax on transfers over that amount will jump from 35% to as high as 55%. This is a strong argument for higher-net-worth individuals and families to consider transferring up to $4.12 million more this year to children and grandchildren. If you are considering such a strategy, keep the following in mind:

- Be sure you have enough left in your name after the transfer to support you for the rest of your life. Provisions that allow reclaiming of transferred assets could also pull them back into the estate later.
- The recipient needs to be mature and stable enough to handle receiving a large gift. If there is any question, consider establishing a trust in the recipient's name to provide structure and oversight.
- Gifts made in prior years that exceed the total estate tax exemption in the year of death can pose a "claw-back" risk, meaning they may be pulled back into the estate.

One strategy affluent families can consider is an irrevocable life insurance trust. When properly structured, the proceeds are excluded from the estate and may be used to offset future estate taxes.

Because of the uncertainties at present, more complex planning will likely only benefit those with estates large enough that they would be taxed regardless of the exemption amount. Others should probably wait to see where the exemption settles before undertaking significant planning.

Then there is the reality of our nation's fiscal situation. Budget deficits and the cumulative national debt have ballooned over the last several years for a variety of reasons. The latest projections included in the President's proposed budget (Chart 1) show a deficit of $1.3 trillion for 2012 and a projected annual deficit of at least $575 billion in each of the next 10 years. Meanwhile, overall national debt is projected to climb from 68% of GDP in 2011 to 78% by just 2014.

Republicans argue these deficits must be controlled by reducing spending and spurring growth through tax cuts. Democrats, on the other hand, cite the Bush tax cuts as the primary driver of growing deficits and propose raising taxes on higher-income taxpayers to resolve the issue. This fundamental disagreement makes the expiration of the 2001 tax cuts increasingly possible. Add in the fact that most of the tax provisions of the 2010 Affordable Care Act take effect in 2013, and it becomes increasingly likely that we could see significant tax increases next year.

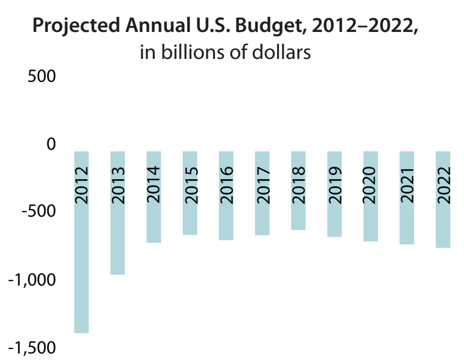
Possible Change No. 1: Capital Gains

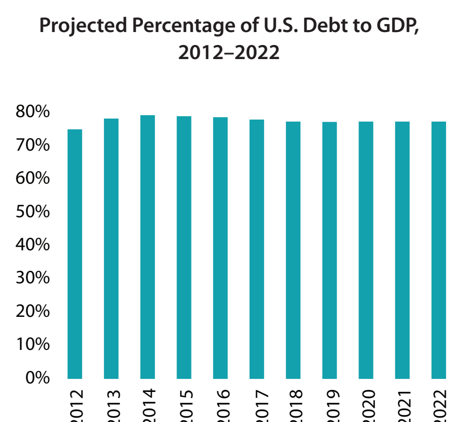
Probably the most significant changes investors could see are in the areas of capital gains tax rates and the treatment of dividend income. For 2012 some taxpayers will enjoy a 0% rate on long-term capital gains, provided their income doesn't exceed the top threshold for the 15% ordinary bracket (taxable income up to $70,700 for couples, $35,350 for singles). Taxpayers in higher brackets will pay a 15% tax on gains. Under existing law, those rates would increase to 10% and 20% for gains realized in 2013. And under the Affordable Care Act, higher-income taxpayers will owe an additional 3.8% tax to help fund the Medicare system, bringing the top rate to 23.8% – a nearly 60% increase.

This is not to suggest that all investors with appreciated positions should sell immediately. Such decisions should be made based on the merits of the investment first, with taxes as a secondary consideration. Capital gain tax rates have a history of fluctuating and, even though 15% is nearly a historical low, it's entirely possible rates

CHART 1:

Projected Federal Budget Deficits





Source: Office of Management and Budget, Budgets of the U.S. Government Fiscal Year 2013. Available at: whitehouse.gov/omb/budget/Overview.

could return to current levels or even lower at some point in the future.

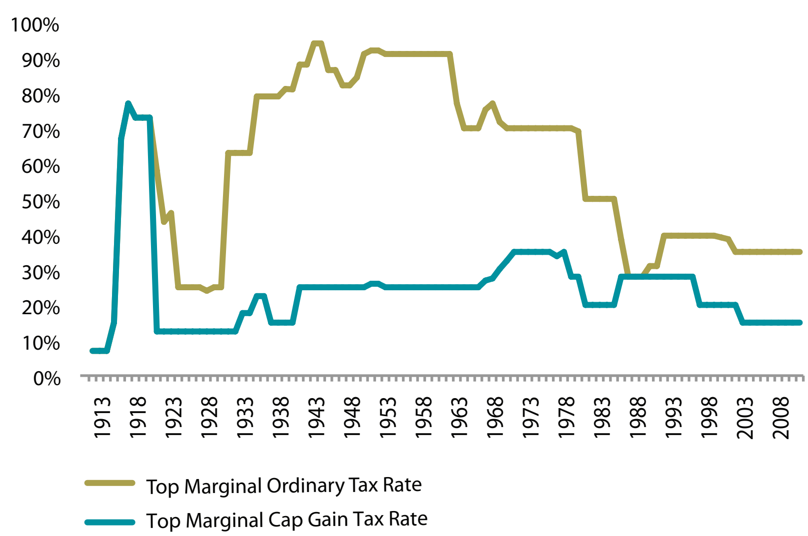
So what can you do in the interim?

- **Accelerate gain recognition into 2012.** If you're approaching year-end and have a position you feel is nearing its maximum price potential, selling in 2012 at a 15% tax would generally be preferable to selling in 2013 at a 23.8% tax. Lower tax rates can even offset the loss of additional price appreciation you might give up by selling sooner. In general, the bigger the unrealized gain you have in the position, the better it has to perform to overcome higher capital gain tax rates.
- **Diversify concentrated positions.** Holders of concentrated positions are often unwilling to diversify those positions because of the tax cost of doing so. The current capital gain tax rate of 15% is at its lowest since 1933 (Chart 2), making this year an ideal time to realize gains at a relatively small tax cost.
- **Rebalance your portfolio.** Asset allocation has been shown to be the dominant factor in determining overall portfolio performance. If your portfolio has found its way out of balance because of over-performance in some areas, the lower tax rates of 2012 can lessen the pain of rebalancing.
- **Take advantage of tax-free gains.** Regardless of what happens in 2013, the 0% long-term capital gain tax rate for taxpayers in the 15% bracket represents an opportunity for those investors to realize some gains with no tax consequences. That rate is scheduled to go back to 10% next year, meaning this may be your last opportunity to completely avoid taxes on some sales.

One strategy we would *not* recommend is selling now to lock in today's tax rate and then immediately repurchasing the asset. This can minimize the impact of future tax increases while leaving the door open for subsequent appreciation

CHART 2:

Top Marginal Ordinary and Capital Gains Tax Rates, 1913–2012



Source: Tax Policy Center, "U.S. Individual Income Tax: Personal Exemptions and Lowest and Highest Tax Bracket Tax Rates and Tax Base for Regular Tax, Tax Years 1913--2012," available at: taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=543&Topic2id=30&Topic3id=39; CCH Incorporated, "2012 CCH Whole Ball of Tax," available at: cch.com/wbot2012/029CapitalGains.asp.

in the position. But do you really want to accelerate a tax cost you wouldn't otherwise pay this year? There is an opportunity cost to paying taxes ahead of time, plus the possibility that tax rates will continue to fluctuate both up and down in the future.

The same warning holds true when using a capital loss carryover to offset those gains. Carryovers should be viewed as assets available to offset future tax liabilities. Using them to offset gains you aren't ready to realize only leads to paying taxes on actual gains down the road.

Possible Change No. 2: Dividends

The 2001 tax cuts created what we now call "qualified dividends," which includes most payments received by stock investors, and taxed them at the same rate as long-term gains (15% for the top brackets and 0% for lower-income taxpayers). The qualified dividend concept is scheduled to go away in 2013, when all dividends would return to being taxed as ordinary income. That means dividends would be taxed next year as high as 39.6% for taxpayers in the top tax bracket.

Additionally, the new Medicare tax on investment income would also apply to dividends, adding another 3.8% tax to the ordinary rate for couples with income over $250,000 (singles over $200,000). This would make the new top tax rate on dividends 43.4% – nearly triple the current rate.

A higher tax on dividend-paying stocks certainly lowers their attractiveness, but it doesn't necessarily mean investors should abandon those positions. However, if the higher tax rate will take too big a bite out of your income, you may want to consider other investment strategies and their implications.

- **Look for alternative sources of portfolio yield.** Yield can be found in a variety of investment types, although they each come with their own form of risk that differentiates them from stock investments. Annuities, master limited partnerships and REITs can all be good sources of yield, but they each have different risk/reward characteristics than traditional stocks and shouldn't necessarily be viewed as equivalent. With current interest rates extraordinarily low, bond investments are not providing the same yields they have historically. Adding cash flow via bonds may mean looking to lower-quality bonds, which again entails different risks than stocks.
- **Consider how companies may alter payment strategies.** When the dividend tax rate was cut in May 2003, annual dividend payments by S&P 500 companies rose 18% over the next 12 months. When special one-time dividends were added, there was a 23% increase, and 22 S&P 500 companies that did not previously pay dividends started doing so.[2] This indicates the tax treatment of dividends does impact a company's willingness to pay them.

Ultimately, if the relative stability of the stock and regular cash flow from the dividend are what appeal to you, it may prove difficult to find an adequate replacement before selling.

Possible Change No. 3: Ordinary Tax Rates

Ordinary tax rates are also scheduled to increase across the board in 2013, making the difference between taxable and tax-exempt bonds even greater. The return of the phaseouts of itemized deductions and personal exemptions for higher-income taxpayers will be another, less obvious tax increase. The good news is bond investors also have options for managing their portfolio in light of a changing tax situation (Table 1).

- **Move toward tax-exempt bond investments.** Municipal bonds pay interest that is federally tax-exempt, making them attractive to taxpayers in higher tax brackets. On the contrary, taxable bonds usually pay a higher interest rate than muni bonds, making them more appropriate for those in lower brackets. Table 1 shows the after-tax return on bonds paying various yields at different tax rates. As you can see, the interest rate tax-exempt bonds must pay to provide a better after-tax return than taxable bonds goes down as tax rates go up.

TABLE 1:

Marginal U.S. Tax Rates and the Required Yields From Equivalent Taxable Bonds, 2012 and 2013

			Tax-Exempt Equivalent Yield to a Taxable Bond Paying							
	Marginal Tax Rate		3%		4%		5%		6%	
MFJ Income Range	In 2012	In 2013	In 2012	In 2013	In 2012	In 2013	In 2012	In 2013	In 2012	In 2013
$0–17,400	10%	15%	2.70%	2.55%	3.60%	3.40%	4.50%	4.25%	5.40%	5.10%
$17,400–70,700	15%	15%	2.55%	2.55%	3.40%	3.40%	4.25%	4.25%	5.10%	5.10%
$70,700–142,700	25%	28%	2.25%	2.16%	3.00%	2.88%	3.75%	3.60%	4.50%	4.32%
$142,700–217,450	28%	31%	2.16%	2.07%	2.88%	2.76%	3.60%	3.45%	4.32%	4.14%
$217,450–388,350	33%	39.8%	2.01%	1.81%	2.68%	2.41%	3.35%	3.01%	4.02%	3.61%
$388,450 and up	35%	43.4%*	1.95%	1.70%	2.60%	2.26%	3.25%	2.83%	3.90%	3.40%

**The top two brackets in 2013 include a 36% or 39.6% ordinary tax rate plus 3.8% Medicare tax on investment income.*

What this all means is that bond investors concerned about higher tax rates eating away at their returns may become more inclined to look at tax-exempt bonds. As the demand for these bonds increases, so will their prices, which have an inverse relationship to bond yields. So if an investor wants to shift toward tax-exempt bonds, they'll want to do so before demand raises prices, effectively negating the better yield.

The Bottom Line

Heading into 2013, investors face a potential sandstorm of changes with serious implications for portfolio strategy, including when to recognize gains, the significance of dividends and the importance of having the appropriate type of bond investments. Taxes could be significantly higher next year, and the months remaining in 2012 offer the last chance to prepare. These strategies should be discussed with your Financial Advisor and tax professional now, rather than waiting for clarity that may come too late for you to react.

[1]Tax Policy Center, "Baseline AMT Projections, Current Law and Current Policy, 2011-2022," June 3, 2011.

[2]Cato Institute, "Show Me the Money! Dividend Payouts after the Bush Tax Cut", October 11, 2004, available at: cato.org/pubs/briefs/bp88.pdf.

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