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Uncertainty Dominates Tax Planning Climate

Many favorable tax laws enacted over the past decade are scheduled to sunset this December unless Congress once again moves to extend them.

While the bulk of the tax burden would fall on the highest earning Americans, all investors would feel the pinch to some degree.

The old adage, "nothing is more certain than death and taxes," still holds true, but exactly how much tax investors will be liable for after December 31, 2012, remains something of a mystery. Many favorable tax laws enacted over the past decade are scheduled to sunset this December unless Congress once again moves to extend them.

Post-2012 Tax Changes

Some major tax changes currently scheduled to take place starting in 2013 include:

- Federal income tax brackets. The 10% tax bracket will disappear, and the 25%, 28%, 33%, and 35% rates will revert to 28%, 31%, 36%, and 39.6%, respectively.
- Capital gains. Short-term capital gains will continue to be taxed at ordinary income tax rates, although those rates will generally be higher. Long-term capital gains will generally increase to a maximum of 20%, up from 15%.
- Dividend income. Dividends will be taxed at regular income tax rates rather than at the lower "qualified dividend" rates of 15% or less.

In addition, a new tax on investment income of high-earning taxpayers, which was created as part of the health care reform legislation, will take effect in 2013. Specifically, the "Unearned Income Medicare Contribution" will be equal to 3.8% of the lesser of:[1]

- **Your net investment income** -- generally, net income from interest, dividends, annuities, royalties and rents, and capital gains.
- **Your modified adjusted gross income** -- income that exceeds $200,000 ($250,000 if married filing a joint federal income tax return; $125,000 if married filing a separate return).

Generally, only those taxpayers with incomes that exceed the dollar thresholds listed above will be subject to the additional 3.8% tax. Note that interest earned on tax-exempt bonds or on qualified retirement plan and IRA distributions are not considered investment income with regard to this tax.[1]

According to the Tax Policy Center, when you combine the effect of the impending tax hikes with the cutbacks in personal exemptions and itemized deductions that are on track to resume in 2013, the new rates on long-term capital gains and qualified dividends rise to 21.8% and 40.8%, respectively. Add in the 3.8% Medicare tax on unearned income, and the top rate jumps to 25% on capital gains and 44.6% on dividends.[2]

Keep in mind that these numbers will apply almost exclusively to the highest earning Americans. Still, if the tax increases detailed here are allowed to take effect, all investors will be affected to some degree.

What Investors Can Do

As you plan ahead to 2013, here are a few strategies that may help to mitigate any new exposure to taxes you may encounter.

- **Seek dividend growth over dividend yield.** If you are an income-focused investor, consider broadening your approach to include a balance of growth and income stocks. Within your income allocation, consider selling shares of high-yielding dividend stocks in favor of those with moderate yields and steady dividend payment growth.
- **Invest in municipal bonds.** Municipal bonds remain one of the few tax-exempt investments and sources of cash flow. Interest on munis is exempt from both federal and state taxes as long as the bond is issued in the state where the investor claims residency. Further, for purposes of the Medicare 3.8% tax, muni income is not considered net investment income nor is it considered part of your modified adjusted gross income.[3]
- **Maximize contributions to qualified retirement plans.** Contributions to employer-sponsored plans reduce current taxable income, and distributions from such plans are not considered net investment income for the purposes of the Medicare 3.8% tax. For 2012, you can contribute up to $17,000 in a qualified employer plan with $5,500 in catch-up contributions for those aged 50 and older. For IRAs, the maximum contribution is $5,000 with an additional $1,000 in catch-up contributions.
- **Donate highly appreciated stocks to charity.** Doing so helps you to keep up with your charitable giving while also avoiding capital gains taxes on low-basis-cost investments.

Absent a crystal ball, the best course of action may be to stay close to your financial planner and CPA throughout the year, and listen to their recommendations about how best to take advantage of the current, relatively friendly tax climate while you still have time.

[1]Source: *Medicare.org*.

[2]Source: The Tax Policy Center.

[3]Municipal bonds are subject to availability and change in price. They are also subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax, and capital gains to the federal capital gains tax. State and local taxes may also apply.