Tax Outlook 2013 -- For Investors, Uncertainty Requires Proactive Planning

Uncertainty over the future tax landscape looms large as we enter the final months of 2012.

With the planning window growing ever shorter, investors need to take a proactive stance, reviewing their portfolios and making preemptive investment moves, where appropriate.

The presidential election -- and the political developments that it is expected to foment -- will likely determine the fate of a number of tax laws, potentially creating new taxes and/or reinstating higher taxes on various types of investment income in 2013.

With the planning window growing ever shorter, investors need to take a proactive stance, reviewing their portfolios and making preemptive investment moves, where appropriate, to help mitigate any new exposure to investment-related taxes.

What's at Stake?

Generally, three tax rules affecting investment income are in play for 2013.

Medicare tax. To help pay for health care reform, the *Patient Protection and Affordable Care Act* calls for a 3.8% Medicare tax on investment income for high-earning taxpayers. The new tax will apply to single tax filers with a modified adjusted gross income (MAGI) of $200,000 or greater or joint filers with a MAGI of $250,000 or more.

The tax will apply to "net investment income," which is defined as interest, dividends, royalties, annuities, rents and other passive activity income, capital gains from the sale of property (not used in active business), and trading of financial instruments and commodities.

Importantly, net investment income does *not* include distributions from IRAs or qualified retirement plans, annuity payouts, or income from tax-exempt municipal bonds, among other items.

Higher dividend tax rate. The current 15% tax rate on qualified dividends has been in effect since 2003, when President George W. Bush signed the Jobs and Growth Tax Relief Reconciliation Act into law.[1] In 2013, all dividends will be taxed at the investor's ordinary income tax rate. For most, these rates are also increasing and will range from a low of 15% to a high of 39.6%.

Higher capital gains tax rate. Similar to dividends, the 15% tax rate on long-term capital gains went into effect in 2003 and subsequent extensions by lawmakers have kept the rate at 15% through this year. In 2013, the rate will increase to 20%, with a qualified rate of 18% for gains in assets held for more than five years. (Short-term capital gains will continue to be taxed at ordinary income tax rates, although those rates will generally be higher.)

Takeaways for Investors

Stay Vigilant. Pay attention to post-election political wrangling, which could alter the current assumed course of events with regard to these and other tax provisions.

If Washington lawmakers once again act to extend the status quo, then no action may be required on your part to avert a bigger tax bite on your investments. If, however, the tax changes are implemented as planned, and you are considering selling securities that have gained in value, be prepared to do so before December 31 to avoid paying a bigger tax bill in 2013.

Offset Gains With Losses. You may also want to consider carrying over investment losses into 2013. Prior-year losses may become more valuable because they would offset capital gains taxed at the higher rate than the rate in effect when you incurred the losses.[1]

Think IRAs and Municipals. With regard to the Medicare tax, the same unknowns apply. Pending the outcome of Election 2012, lawmakers could strike down the new 3.8% tax. If, however, the tax stands, investors may want to consider:

- **Maximizing IRAs and qualified retirement plans.** If you are retired, look for ways to maximize your income from IRAs or qualified retirement plans, since income derived from these plans is not subject to the Medicare tax. Or, if you are still in the workforce and have access to an employer-sponsored plan, contributing as much as you can every year may provide future tax savings.
- **Investing in tax-exempt municipal bonds.** Income from municipals is not considered net investment income for the purposes of the 3.8% tax, nor is it considered part of your MAGI.[2]

Although the current state of tax limbo may be unsettling, it provides a critical window of time to review your investment-related tax issues with a trusted financial and/or tax professional and to prepare for whatever lies on the tax horizon.

This information is not intended to be tax advice and should not be treated as such.

[1]Source: The American Institute of CPAs (AICPA), "Potential Tax Changes Await Investors in 2013," August 1, 2012.
[2]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.