The 2013 Tax Conundrum

By John S. Beliveau, CFA, CFP®, Head of Wealth Management Group
And Michael R. Currie, Head of Trust Department

With the election now over and Congress back from Thanksgiving recess, a tremendous amount of time and attention is being spent on the many potential changes to the tax code for 2013 and beyond. With less than a month left in the tax year, there are still many unknowns as to how it all will look come January. To try and help make sense of this tax uncertainty as it relates to one's investment portfolio and personal finances, we will break it down into two categories: what will happen if nothing gets done, and some reasonable, although still uncertain, expectations.

First, we believe at this point that it is very likely that 'Obamacare' legislation will impose, for taxpayers who have adjusted gross income (AGI) greater than $200,000 ($250,000 for couples), a surtax on net investment income and realized capital gains in the amount of 3.8%. This new tax will apply to interest, dividends, royalties, rents, and capital gains, but not retirement plan distributions or tax exempt interest. We believe that it is unlikely that this new tax will be negotiated away in the coming budget discussions.

Second, if no progress or compromise is reached prior to December 31st, the federal tax code will revert to pre-Bush era levels. This will have an impact on salaries and wages, capital gains, dividends, and estate taxes. The table below highlights a number of these changes.

Income Type	2012 Rates	2013 Scheduled
Ordinary Income - Top Rate	35%	39.60%
Long Term Capital Gains*	15%	20%
Dividends - Top Rate*	15%	39.60%
Estate Tax - Maximum Rate	35%	55%
Estate Tax - Exemption	$5,120,000	$1,000,000
Gift Tax - Maximum Rate	35%	55%
Gift Tax - Exemption	$5,120,000	$1,000,000

** plus 3.8% net investment income surtax for high income taxpayers*

Given the negative impact that reversion to the pre-Bush era tax rates would have on our economy, few believe that the 2013 scheduled rates will persist long after January 2013 even if nothing is accomplished prior to year end.

It is our hope that a compromise can be struck somewhere in between these two ends of the tax range. We are fairly certain that capital gains and dividend tax rates will not go lower, so we have another month to enjoy the low 15% rate on long term capital gains and dividends. We do not believe that the projected 20% long term capital gain tax rate (even with the additional 3.8% surtax) is so much higher that it should push investors to realize substantially higher capital gains in 2012, but it should encourage investors to think about a few tax tactics in the short term.

1. It may be better to realize long term capital gains in 2012 than wait until January or February 2013 if you are fairly certain that you want to dispose of unattractive holdings. <u>However, if a particular stock is fundamentally attractive and expected to be held for many years, then paying the lower tax rate now will only result in less capital being deployed (because of the tax paid on the gain) and compounded over the coming</u>

<u>years, the cost of which may more than offset the benefit of a lower tax bill paid today.</u>

2. If one has realized short term gains year to date, which are taxed at ordinary income tax rates, it does make sense to realize capital losses to offset those gains. Short term capital losses will offset short term capital gains. Long term capital losses may offset short term capital gains only if they exceed the realized long term capital gains for the year. If there are still excess capital losses after offsetting the capital gains, investors can use up to $3,000 of excess capital losses in a given year to offset higher taxed ordinary income.

3. Unrealized long term capital losses that are pushed into 2013 may provide investors a greater tax benefit in 2013 as those losses will offset long term gains that may otherwise be taxed at the higher 20% level (and the additional 3.8% surtax, if applicable).

It is the possible increase in taxation on dividends that may be the most dramatic. We are worried about the effect this tax increase may have on corporate capital allocation decisions. The strong, consistent growth in shareholder dividends paid by companies (financial sector excluded) has been one of the few bright spots in the capital markets over the past ten years. As we know from experience and basic economics, the more the government taxes something, the less of it that gets produced. We do not know how this might play out, but in our current environment of yield-starved investors, this tax increase may prove to be one more challenge to overcome in the financial markets.

Estate tax uncertainty is also causing a fair amount of planning anxiety. It is hard to predict where the estate and gift tax changes will end up, especially given that the revenue raised by these taxes is not terribly significant in the overall scheme of things. Lately, we have heard that the estate and gift tax exemption levels and rates may be an area where the Democrats are willing to compromise in order to get higher tax revenues elsewhere. Few believe that we will go back to the $1 million exemption level and the 55% top estate tax rate, but where we end up is still uncertain. Additionally, we do not know if the estate tax exemption levels and exemption levels for lifetime gifts will remain unified or not. If you recall, before we briefly entered the world of no federal estate or gift tax in 2010, the estate tax exemption was $3.5 million and the lifetime gift tax exemption was $1 million.

While the differences between the current and projected exemption levels are meaningful ($1 million, $3.5 million, $5.12 million, or something else), our bottom line is that we would not advise clients to make major family gifts for estate and gift tax efficiency purposes if it imperils their own long term financial security. And one piece of good news: the annual gift tax exclusion is scheduled to increase from $13,000 to $14,000 (an inflation adjustment) in 2013.

<u>All in all, while we believe that the overall tax burden for many investors will likely increase under most reasonable scenarios next year, we do not expect to recommend major strategic changes to client investment policies or portfolios</u>. We stand ready, however, to evaluate whatever changes may be appropriate to the investment strategy for our clients as these tax issues are resolved, one way or the other.

As with any tax issue, this information is not intended as tax advice, and we strongly recommend you discuss with your tax advisor how these possible tax changes may affect your personal tax situation.

Market Log- December 3, 2012

S&P 500: 1,409.46
10 year T-Note: 1.62%
Crude Oil: $89.09
Gold: $1,704.81

If you have questions or comments regarding this or any other communication from us, please email us at **info@hmpayson.com**.