The Proverbial Can

It's not our job here at Rockwood Wealth Management to complain about the tax code uncertainty presented to us all by congressional inaction. It's not our job here at Rockwood Wealth Management to speculate about if and when certain tax laws will be changed. It's certainly not our job to forecast political outcomes. However, it *is* our job to study and understand the tax laws that are currently on the books—and to position your assets and your long-term plan accordingly. In that pursuit, we thought we would summarize four of the major federal income tax changes that are scheduled to take effect in 2013.

As a bit of background, the year 2012 may be the final year that the so-called Bush tax cuts remain in effect, unless Congress acts to further extend them. The Bush tax cuts, enacted in 2001 and 2003, were originally scheduled to expire in 2011. However, President Obama signed legislation in late 2010 that temporarily extended the Bush tax cuts through 2012.

We'll introduce these tax increases and then outline exactly how Rockwood Wealth Management is proactively taking steps to reduce the impact of these changes on you and your family.

Long-Term Capital Gain Rates

The maximum rate on long-term capital gain is scheduled to increase from 15% to 20% in 2013. Individual taxpayers in the 10% and 15% ordinary income tax brackets currently pay no tax on long-term capital gain. These taxpayers are scheduled to be subject to a 10% long-term capital gain rate in 2013. An 18% maximum rate will apply to capital assets purchased after 2000 and held for more than five years. Additionally, the 3.8% Medicare contribution tax discussed below will increase the effective rate of tax on long-term capital gains for certain higher-income taxpayers to as high as 23.8%.

Dividend Income Rates

The Bush tax cuts created the concept of "qualified dividend income," which currently allows dividends received from domestic corporations and certain foreign corporations to be taxed at lower long-term capital gain rates. Prior to the Bush tax cuts, all dividend income was taxed as ordinary income. If Congress fails to extend these provisions, the qualified dividend income provisions will expire and all dividends will again be taxed as ordinary income.

Most notably, taxpayers in the highest marginal income tax bracket who currently enjoy the 15% rate on qualified dividend income will be taxed at 39.6% for dividends received from the same issuer in 2013. Additionally, the 3.8% Medicare contribution tax discussed below will increase the effective rate of tax on dividend income for certain higher-income taxpayers to as high as 43.4%.

New Medicare Contribution Tax

A new 3.8% Medicare contribution tax on certain unearned income of individuals, trusts, and estates is scheduled to take effect in 2013. This provision, which was enacted as part of the Patient Protection and Affordable Care Act, is scheduled to take effect regardless of whether Congress extends the Bush tax cuts. The 3.8% tax will be imposed on individuals with a modified adjusted gross income exceeding certain thresholds ($250,000 for married individuals filing jointly or $200,000 for unmarried individuals).

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For purposes of this tax, investment income includes interest, dividends, income from trades or businesses that are passive activities or that trade in financial instruments and commodities, and net gains from the disposition of property held in a trade or business that is a passive activity or that trades in financial instruments and commodities. Investment income excludes distributions from qualified retirement plans and excludes any items that are taken into account for self-employment tax purposes.

Marginal Brackets

If Congress allows the Bush tax cuts to expire, ordinary income tax rates will increase for most individual taxpayers beginning in 2013. As discussed below, qualified dividend income that is currently taxed at long-term capital gain rates will be taxed at these higher ordinary income rates. The table at the bottom of the page shows scheduled rate increases.

In 2013, the 28% bracket threshold for those married filing jointly will decrease to $58,900 from $70,700. This change will have the effect of putting more middle-income joint filers in the 28% bracket and increasing the "marriage penalty" for taxpayers.

Our Proactive Planning

Let's take a moment to examine three of the strategies we at Rockwood implement to reduce the negative impact of these changes:

1. Use of low-turnover institutional marketwide investment vehicles: Mutual funds are flow-through vehicles for tax purposes—meaning that if a mutual fund manager is constantly buying and selling stocks in the fund, the tax consequences of that trading activity flows through to the investors in the fund. We implement portfolios using ultra-low-turnover institutional core equity funds that minimize unnecessary or speculative buying and selling. Fewer trades inside the fund keep fund expenses down and reduce taxes.

2. Strategic asset location: One of our best tools for the mitigation of tax liabilities associated with investment portfolios is the practice of "asset location." By locating the assets that pay the most dividends, distribute the most income, and are generally the most tax-inefficient inside the tax deferred accounts (such as IRAs, 401(k)s, etc.), we can shelter that income from unfavorable tax treatment. Conversely, asset classes that are tax-efficient should reside in taxable accounts.

3. Tax management in taxable accounts: Our portfolio management practices follow a tax-advantaged approach by monitoring for cumulative gains and losses in taxable accounts. While rebalancing portfolios to achieve their target weightings, we minimize the realization of capital gains when selling securities. Specifically, those shares of the specific security with the highest cost are typically selected when a sale is warranted. If the highest-cost shares produce short-term capital gains, the highest-cost shares with a long-term holding period may be selected instead. Securities with capital losses are also identified and sold to offset realized capital gains when appropriate. Within the institutional core equity mutual funds, additional screens are applied to minimize the effect of dividend distributions on after-tax returns.

We realize that the specter of tax increases has cast a pall over the forthcoming arrival of 2013. However, prudent and proactive integration of portfolio management and tax management means that clients of Rockwood will not pay any more tax than is absolutely necessary.

Federal Income Tax Brackets					
Unmarried Filers		Married Joint Filers		Marginal Rate	
Over	But Not Over	Over	But Not Over	2012	2013
$0	$8,700	$0	$17,400	10%	15%
8,700	35,350	17,400	70,700	15%	15%
35,350	85,650	70,700	142,700	25%	28%
85,650	178,650	142,700	217,450	28%	31%
178,650	388,350	217,450	388,350	33%	36%
388,350	...	388,350	...	35%	39.6%

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