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HELPING OUR CLIENTS BUILD AND MAINTAIN WEALTH WITH AN UNWAVERING FOCUS ON CLIENT SERVICE AND COMMUNICATION.

Tax Changes Decoded

Get ready for a raft of tax law changes. . . probably. We are facing the expiration of two different initiatives - the "Bush" tax cuts that have been extended through the end of this year and the 2% payroll tax cut that was part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. We are also facing the addition of another initiative, the payroll and unearned income taxes as part of the Health Care and Education Reconciliation Act of 2010, better known as "Obamacare". These three things are combining to create a confusing suite of changing tax brackets, sun-setting deduction and exemption provisions, income thresholds, payroll changes. . . you name it.

In an effort to clarify some of these changes, we will highlight those we feel have the potential to affect you, provide suggestions on how to address them, and give illustrations on how they may affect different client situations. There is potential that some of these will be addressed by Congress before the end of the year, and/or early into the new year. Stay tuned!

There are more changes than just those we're mentioning, but these are the ones we believe will affect the majority of our clients. As with all tax information, please discuss these with your tax professionals. We are prepared to discuss how to handle these changes from an investment and financial planning standpoint, but we leave the estimating on how they will affect your specific income taxes to your tax professional.

Changes that affect everyone

Tax Bracket Changes

After December 31, 2012, we're scheduled to go from six federal tax brackets to five. That results in the elimination of the 10% bracket, and a 3-5% tax increase in each remaining bracket.

Planning considerations: Recognize income in 2012 where possible. If you are not maxing out retirement plan contributions, consider stopping your contributions the remainder of this year to the extent you can add that amount to what you save next year, effectively pushing as much as possible to deduct next year. In addition, you may want to consider converting traditional IRA assets to a Roth before year end to take advantage of the lower brackets this year (assuming the Roth makes sense for you in the first place).

Changes that affect almost everyone

2% Social Security Payroll Tax Reduction Expiration

Individual worker's wages up to a certain limit ($110,100 in 2012) are assessed a social security payroll tax of only 4.2% as opposed to the usual 6.2%. For 2013, this 2% reduction is set to expire, so all wages up to $110,100 or so will be assessed the former 6.2% rate. The net effect is, you guessed it, 2% more removed for the first $110,100 in an individual's earnings.

Planning considerations: Wage earners may want to consider negotiating for bonuses to be paid out in 2012 to take advantage of the lower Social Security tax rate. Similarly, self-employed persons may want to accelerate income into 2012 by increasing revenues or deferring deductions.

Estate Tax Exemption

The estate tax exemption is scheduled to drop from its current $5,120,000 to $1,000,000 in 2013, and the estate tax rate is scheduled to increase from 35% to 55%. This change will shift a substantial amount away from "pour-over trusts" and back to surviving spouses, and therefore eventually back to a taxable estate.

Planning considerations: Review your estate documents and consider strategies to shift assets and add liquidity to estates. If you or other family members were considering adding assets to an irrevocable trust, you have three more months to add $4 million more than you can next year.

Capital Gains and Qualifying Dividend Taxes

This year, long-term capital gains are taxed at a maximum rate of 15%. If you are in the 10% or 15% tax bracket, you pay 0%. Starting next year, the maximum tax rate on long-term capital gains will increase to 20% for most taxpayers, with a 10% rate applying to those in the lowest tax bracket.

Additionally, while the current long-term capital gains rates currently apply to qualifying dividends, starting in 2013 all dividends will be taxed at ordinary income tax rates.

Planning considerations: Sell appreciated capital gain assets in 2012 to save on future taxes, especially if you are in the 10% or 15% brackets where you may pay $0 capital gains this year instead of 10% in the future. This provides an opportunity to lock in a higher cost basis with no current tax impact.

Changes that affect most everyone with high earned income

.9% Unearned Income Medicare Payroll "Contribution"

Wages are currently subject to a 2.9% Medicare tax. Workers and employers pay 1.45% each. Self-employed people pay both halves of the tax (but are allowed to deduct half of this amount for income tax purposes). Unlike the payroll tax for Social Security, which applies to earnings up to an annual ceiling, the Medicare tax is levied on all of a worker's wages without limit.

Under the provisions of the new healthcare law, most taxpayers will continue to pay the 1.45% Medicare tax, but single people earning more than $200,000 and married couples earning more than $250,000 will be taxed an additional 0.9% (2.35% in total) on the excess wages over those base amounts. Ex: A married couple with wages of $300,000 will pay 1.45% on the first $250,000, and 2.35% on the $50,000 above that.

Employers will collect the extra 0.9% on wages exceeding $200,000/$250,000. However, they will not be responsible for determining whether a worker's combined income with his or her spouse made them subject to the tax. Instead, some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid.

Planning Considerations: Married couples with combined incomes approaching $250,000 will have to keep tabs on both spouses' pay to avoid an unexpected tax bill.

3.8% Medicare Surcharge on Unearned Income for Individuals, Trusts and Estates

Under current law, the Medicare tax only applies to wages and self-employment income. Starting in 2013, a new 3.8% tax will be imposed on single taxpayers with adjusted gross income (AGI) above $200,000 and joint filers with AGI over $250,000 who have "net investment income". This 3.8% will be assessed on the lesser of the AGI above $200,000/$250,000, or the net investment income.

For trusts and estates, this 3.8% will be assessed on the lesser of the undistributed net investment income or the amount by which adjusted gross income exceeds the top inflation-adjusted bracket for estate and trust income, which is expected to be approximately $12,000 in 2013.

Net investment income is interest, dividends, royalties, rents, nonqualified annuity income, gross income from a trade or business involving passive activities, and net gain from disposition of non-business property. The new tax will not apply to income in tax-deferred retirement accounts such as 401(k) plans and IRAs.

Planning considerations: Similar to long-term gains taxes, recognize revenue for these items in 2012 where possible. Fiduciaries of trusts with net investment income that is expected to exceed $12,000 in 2013 should consider the impact that the 3.8% surtax will have on accumulated trust income and on distributions to beneficiaries with high incomes.

Reduction of Itemized Deductions and Personal Exemptions

Beginning in 2013, itemized deductions and personal and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs). The itemized deductions phase outs begin at adjusted gross income levels above $173,650 for both joint and single filers. The personal exemption phase outs begin at adjusted gross income levels above $178,900 for single filers and $268,250 for joint filers.

Planning considerations: Tax deferred savings become that much more valuable next year. If you are not maximizing retirement plan contributions, consider doing so.

And as if that wasn't bad enough. . .

Reduction of child tax credit

For those taxpayers able to claim child tax credits, the credit will decrease to $500 per child from the current $1,000 per child.

Planning considerations: Unfortunately, there's not much we can do about this one.

So how might these changes affect me?

If there's one things that's a certainty in life, it's that taxes will never be a quick and easy discussion. Everyone's situation is different thus warranting one-on-one attention from a tax professional. That said, let's take a look at how these tax law changes would likely affect a few different situations. Please use these examples as a catalyst in helping you create the list of items to discuss with your tax professional. As always, we are here to discuss the impact of these changes on your investments and on your ability to achieve your financial goals.

Married Couple with 2 Children

Total household gross income is $220,000, they contribute to retirement plans, and they also have some taxable savings yielding interest, qualified dividends and long term capital gains. The items in this article that are changing for 2013 would cause them to pay approximately $7,261 more in 2013 than 2012 for the same amount of income, deductions and exemptions:

Tax attributable to:	2012 tax	2013 tax
2% Social Security (OASDI) Change	$6,724	$9,926
Wages, etc. Federal Income Taxes	$32,016	$35,440
Tax increase due to phasing out deductions	$0	$275
Qualified Dividends Taxes	$300	$560
Long-Term Capital Gains Taxes	$300	$400
	$39,340	$46,601

Same Couple with Stock Options

Consider the same couple faced with deciding when to recognize $350,000 in taxable stock option income, **resulting in a ~$37,000 difference!:**

Tax attributable to:	2012 tax	2013 tax
2% Social Security (OASDI) Change	$6,724	$9,926
Wages, etc. Federal Income Taxes	$140,443	$155,484
Tax increase due to phasing out deductions	$0	$4,509
Tax increase due to phasing out exemptions	$0	$2,166
Qualified Dividends Taxes	$300	$800
Long-Term Capital Gains Taxes	$300	$400
3.8% Unearned Inc. Medicare Surcharge	$0	$11,552
	$147,767	$184,837

As you can see, all else being equal, there appears to be ample reason for considering an exercise of those options in 2012. In addition to higher tax brackets next year, there is also the re-introduction of the deduction and exemption phase-outs which are also more likely to kick in as options are exercised resulting in a substantially higher tax bill.

Single Working Taxpayer

Consider the impact of these changes on a single 35 year old with no dependent children. Total gross income is $124,400, also with retirement plan contributions, and small amounts of taxable interest, qualified dividends and long term capital gains. The items in this article that are changing for 2013 would cause an approximate $4,800 increase in 2013:

Tax attributable to:	2012 tax	2013 tax
2% Social Security (OASDI) Change	$4,624	$6,826
Wages, etc., Federal Income Taxes	$21,909	$24,300
Qualified Dividends Taxes	$150	$310
Long-Term Capital Gains Taxes	$150	$200
	$26,833	$31,636

Retired Married Couple

Consider the impact of these changes on a retired couple with no dependent children. Total gross Social Security income is $30,000 in addition to $15,000 from retirement plans. They also recognize taxable interest, qualified dividends and long term capital gains income. The items in this article that are changing for 2013 would cause an approximate $1,735 increase for these items.

Tax attributable to:	2012 tax	2013 tax
Social Security, etc., Federal Income Taxes	$1,430	$2,415
Qualified Dividends Taxes	$500	$750
Long-Term Capital Gains Taxes	$0	$500
	$1,930	$3,665

Case Footnotes

Case 1: Married 47 year olds with 2 children. $220,000 gross wages. $22,000 401(k) contributions. $2,000 taxable interest income. $2,000 qualified stock dividends. $2,000 long term capital gains. $26,812 itemized deductions. 4 personal exemptions. For the stock option decision, itemized deductions increase to $45,362.

Case 2: Single 35 year old. $124,400 gross wages. $10,000 401(k) contributions. $1,000 taxable interest income. $1,000 qualified stock dividends. $1,000 long term capital gains. $10,000 itemized deductions. 1 personal exemption.

Case 3: 67 year old retired couple. $30,000 social security income. $15,000 withdrawal from retirement plans. $10,000 taxable interest income. $5,000 qualified stock dividends. $5,000 long term capital gains. Standard deductions. 2 personal exemptions.

Please note, this list does not encompass all changes, but rather those that we feel may impact our clients from a financial planning standpoint. Although all information has been assembled from sources thought to be reliable, we cannot guarantee its accuracy. Please consult your tax professional.

Our Take

Given the host of tax law changes and government budget cuts that are due to kick in at the beginning of 2013, we have to consider how the economy and markets may be affected. As for the economy, it's our position that we would certainly see a slowdown as a result of the reduction in disposable income related to the tax increases as well as cuts in government spending. The question remains whether we'll have enough underlying growth by year end to take from once all the changes kick in to avoid recession (assuming they go into effect as planned). We'll just have to wait and see how this plays out.

In thinking about impacts of these items on the stock market, we're not quite as concerned. Yes, it's true that if the economy takes a hit, then corporate profits will almost certainly be affected leading to potentially lower stock prices. But, that may not necessarily mean that the market is headed for its own "fiscal cliff" over the medium to longer term. There are some other factors that may offer enough support to current stock prices to mute the effect of a less than vibrant economy. They are as follows:

Current Market Valuation – The market currently trades at a forward multiple of roughly 14 times earnings, which based on historical standards is below average. That's not to say that stocks are incredibly cheap, but it would be an interesting argument to suggest that they're in bubble territory at this point. Furthermore, when looked at relative to the incredibly low interest rates being offered on bonds and cash, stocks appear even cheaper.

Current Sentiment Levels – According to the Investment Company Institute, since 2008 and as of the end of the first quarter of 2012, $158 billion dollars have flowed out of equity mutual funds. In contrast, over the same period $1.36 trillion flowed into bond funds worldwide. This incredible imbalance suggests high levels of skepticism around the stock markets ability to deliver investment performance. Not coincidentally, it's usually these broad divergences in sentiment that ultimately jumpstart new secular bull markets.

Long period of poor stock market performance – Although the simple fact that the S&P 500 is currently lower than it was in March of 2000 is not necessarily a reason for it to rise in value, it does support the notion that since most investors don't feel particularly sanguine about its ability to do much of anything good, the market may be nearing the end of a very long "reset" process. Since valuations and expectation got so wildly out of control coming into the last decade, it makes sense that a good amount of time may be needed to bring both of these things back to reasonable levels before staging another bull market. Looking at previous lengthy bouts of poor stock market performance, we make two primary observations. They tend to follow periods of market outperformance and at the end of them, there is a high degree of pessimism about the stock market in general and its ability to generate meaningful returns going forward.

So in sum, although the pending tax law changes and "fiscal cliff" issues heading into next year have the potential to slow the economy noticeably, we don't think they necessarily spell longer term doom for the markets. We do however expect high levels of volatility throughout the process which could result in some unnerving market corrections and are planning accordingly for the short to medium term. Please stay tuned for our Market Outlook edition of this newsletter next month which will highlight our Core Diversified Portfolio adjustments for the next six months. Our actively managed strategies will adjust automatically as needed. The key, we believe, is to invest in such a way where we can minimize the effect this volatility has on our portfolio over time. Our clients are well prepared.

Have a great October!

Cadence Wealth Investment Department

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Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

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