If we had to give 2012 a name, we could probably call it the *Year of Uncertainty*. The pending fiscal cliff and the ongoing economic issues in the eurozone have combined to make investors more concerned about their future financial plans than perhaps ever before. And one of their biggest worries is taxes.

Although we are currently enjoying the lowest income tax rates in 20 years and the lowest capital gains rates since World War II, this is about to change. Working with your financial and tax advisors to develop a tax-diversified approach to your portfolio may be the best way to navigate the current environment. Let’s take a closer look at the upcoming changes and potential solutions for addressing them.

**Recent developments**
Starting in 2013, the 2010 Patient Protection and Affordable Care Act will increase taxes for high-income taxpayers, including estates and trusts. The increases will come in the form of two new taxes:

1. Medicare Hospital Insurance (HI) payroll tax increase of 0.9 percent
2. New 3.8-percent surtax on most investment income

With the Supreme Court upholding of the health care act, it is very likely that these two taxes will indeed go into effect.

In addition, federal income, capital gain, gift, and estate tax rates are scheduled to increase for all taxpayers in the upcoming tax year, unless Congress acts to extend the Bush-era tax cuts. Dividends will return to ordinary income rates as high as 43.4 percent, and long-term capital gains may be taxed as high as 23.8 percent.

There are some taxes that are *not* scheduled to change, though. Taxpayers exposed to the Alternative Minimum Tax (AMT) will continue to find it hard to take advantage of tax planning strategies. Most tax deductions allowed under the regular tax calculation are ignored under AMT, and income normally excluded from taxes may be added back into AMT income.

**What is this new investment income surtax?**
The new investment income surtax (aka health care surtax) affects taxpayers with wages and net earnings above $200,000 (single), $250,000 (married filing jointly), or $125,000 (married filing separately). For trusts and estates, the threshold is based on the dollar amount at which the 39.6-percent marginal tax bracket begins for these entities (approximately $12,000).

The following types of investment income will be affected:

- Taxable interest
- Capital gains
- Dividends
- Nonqualified annuity distributions
• Royalties
• Rental income

The following income is *exempt* from the new surtax:

• Distributions from retirement accounts (e.g., pensions, 401(k)s, and IRAs)
• Income generated from municipal bonds
• Social security
• Income from a trade or business
• Income subject to the passive activity rules
• Self-employment income

The sale of a home could trigger the tax, but only the proceeds in excess of the personal residence exclusion would be taxed. For qualified individuals, the exclusion protects the seller from taxes up to $250,000 of gain; for married couples filing jointly, the exclusion applies to a gain of up to $500,000.

**Calculating the tax.** For individuals, the 3.8-percent health care surtax is applied to the lesser of net investment income or the excess of modified adjusted gross income (MAGI) over the applicable threshold.

For example, Mark and Sue Taxpayer have earnings from wages of $175,000 and investment earnings of $100,000, for a total MAGI of $275,000. According to the rule, the 3.8-percent surtax is applied to the lesser of $100,000 (net investment income) or $25,000 (excess MAGI over the $250,000 threshold for married filing jointly). In Mark and Sue’s case, only $25,000 of their investment income is subject to the health care surtax. The entire $100,000 of net investment income is subject to either capital gains or ordinary income tax, depending on the nature of the income.

**Tax planning strategies for consideration**

**Sell an investment.** Though it rarely makes sense to pay taxes before you have to, if you are in the highest tax brackets and expect to sell an investment in 2013, it may be advantageous to do so in 2012 instead.

For instance, if you defer selling an asset until 2013, when the capital gain tax rate increases from 15 percent to 23.8 percent, it could take you more than seven years to break even because of the higher taxes incurred. But be aware that the sale could indirectly increase your AMT exposure. Here is why: under AMT rules, the maximum long-term capital gain and qualified dividend rates are still 15 percent in 2012, but gains and dividends can push total income into the phase-out range for AMT exemptions. Always ask your tax advisor to run the numbers before you make a decision.
Exercise employee stock options. Look at nonqualified employee stock options that expire in the next couple of years. Even though an exercise will trigger ordinary income tax, doing so in 2012 will not trigger the increased 0.9-percent Medicare HI payroll tax.

- Consider options that are deep in the money or have underlying stock that is expected to appreciate. An exercise followed by a sale may not only save taxes, but it could also potentially reduce a concentrated portfolio.
- If you decide to exercise stock options before the end of the year, try to avoid doing so during the tax-loss harvesting season. Rapid sell-offs can artificially reduce prices just when you decide to take action.

Invest in tax-exempt municipal bonds. These investments may become more attractive because the interest they generate is not subject to the 3.8-percent health care surtax; it is also generally exempt from federal tax and from state tax for residents living in the issuing state. Keep in mind that although private activity municipal bonds are tax-exempt for regular federal taxes, they are subject to AMT; an individual who otherwise pays little or no tax has a tax liability under AMT.

When working with an advisor to determine whether tax-exempt bonds have a place in your portfolio, don’t let the desire to avoid taxes lead you to an asset allocation that’s inappropriate for your financial situation and objectives.

- If liquidity prior to maturity is a concern, be aware that rising interest rates typically cause bond prices to fall.
- Even if interest rates remain low, investors reacting to financial headlines can engage in indiscriminate selling and cause bond prices to plummet.

Consider converting to a Roth IRA. Distributions from retirement accounts and IRAs are not subject to the 3.8-percent health care surtax. Assets in traditional IRAs and employer-sponsored retirement plans generally grow tax-deferred until they are withdrawn; in the case of Roth IRAs, however, qualified distributions are tax-free.

- Should you invest in a traditional IRA or a Roth IRA? Although distributions from retirement plans are exempt from the surtax, they may increase ordinary income above the high-income thresholds. This would result in other investment or earned income becoming subject to the tax. Therefore, you should consider converting traditional IRAs to Roth IRAs in 2012. Paying taxes on the conversion sooner may allow future distributions to escape the scheduled tax increases later. This only makes sense if you can pay the tax with money from outside the IRA.
- Roth conversion. If you decide that a Roth conversion makes sense, keep in mind that you have until October 15, 2013, to recharacterize an IRA converted in 2012. If you have several Roth accounts and the value of one goes down, you can recharacterize that account and avoid paying unnecessary taxes.

Purchase life insurance or annuities. These types of tax-deferred investments can still make sense, even though their distributions may be subject to the new investment surtax. Although distributions from life insurance and annuities are taxed at higher ordinary income tax rates, the benefit of long-term tax deferral can offset the higher rates. The taxpayer’s holding period will
be critical to this decision. For example, if you defer $100,000 today and expect your tax rate to increase from 35 percent to 43 percent, assuming a growth rate of 6 percent, it will take almost six years to break even; the higher the assumed growth rate, the earlier the break-even year.

- **Cash value life insurance.** This may be particularly attractive to individuals age 40 and younger, mainly because they may have time to maximize the benefits of tax deferral. It has the additional advantage of providing a death benefit that is substantially higher than the account value. Life insurance distributions taken as loans and withdrawals of basis are potentially tax-free if managed properly. Remember that loans and withdrawals generally reduce the death benefit for the family, may decrease guarantees, and can increase the risk of a policy lapse.

**Analyze existing stocks and mutual funds.** Portfolios of stocks and mutual funds can also be managed to take advantage of tax-deferral opportunities.

- Consider making your portfolio more tax-efficient by taking a long-term perspective, investing in funds with low turnovers, and harvesting tax losses.
- Holding bonds in retirement vehicles and keeping stocks in taxable accounts are additional ways to take advantage of these investments’ tax profiles.
- Oil and gas investments can also make sense for some (Keep in mind that specific suitability requirements may apply.); the right deal may enable large write-offs of intangible drilling costs in early years and benefit from depletion allowances in later years.

**Achieving tax diversification**

Just as a portfolio can be overly concentrated in a single stock position, it can also be overly weighted in assets with the same tax characteristics. Retirees are better positioned if they enter retirement with portfolios that are tax-diversified; diversification can help middle-income retirees stay under the investment surtax threshold and reduce how much of their social security benefits are taxed. With an optimum mix of investments—taxable, tax-deferred, and tax-free—you may end up with the highest after-tax yield.

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