The Financial Navigator – December Newsletter

Happy holidays to all. As we near the end of 2012 it may seem as Yogi Berra use to say - “It's deja vu all over again”. We again face much uncertainty concerning next year’s tax rates as we approach the ‘Fiscal Cliff’; just like we did in the fall of 2009. Congress and the President are supposedly hard at work negotiating whether the ‘Bush’ tax cuts will be extended for all, just the middle class, or whether taxes for all will be increased. With only three weeks left in the year the bottom-line is you need to be prepared to act because if Congress finalizes the tax package at the last minute you will only have until December 31st to react. Below is a summary of what the ‘Fiscal Cliff’ is and some end of year tax ideas that may prove helpful.

In addition, some have expressed concern about future investment returns as the US tries to solve its significant debt issues and determine how to fund the current size of the government. Below is a reprint an article from 2009 titled *The Road to Serfdom*, that discusses stock market returns in countries that have what the author calls a more ‘socialistic’ approach to governing. Although a touch outdated, it does provide some surprising results that are still valid three years later.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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The ‘Fiscal Cliff’ and 2012 End of Year Tax Planning

If Congress and President Obama do not act to avert this perfect storm of legislative changes, tax increases and significant budget cuts, America will, in the media's terms, "fall over the cliff." Among other things, it will mean a tax increase the size of which has not been seen by Americans in 60 years. The Tax Policy Center reports that middle-income families will pay an average of $2,000 more in taxes in 2013. Many itemized deductions will be subject to phase-out, and popular tax credits like the earned income credit, child tax credit, and American opportunity credits will be reduced.

Your marginal tax rate is the tax you pay on each additional dollar of income you earn. As your income rises, your marginal tax rate (better known as your tax bracket) rises. For 2012, the tax brackets are 10%, 15%, 25%, 28%, 33% and 35%. If Washington does not act, those rates will go up respectively to 15%, 28%, 31%, 36% and 39.6%.

The potential expiration of the Bush-era tax cuts also affects tax rates on investments. The long-term capital gains tax rate will increase from 15 to 23.8%, including the Affordable Health Act

3.8% tax on capital gains for upper income citizens, and qualified dividend rates will increase to the individual's marginal tax rate up from a fixed 15% under the current plan. This not only affects Wall Street investors, but also retirees and retail investors, who are withdrawing funds from qualified retirement plans and brokerage accounts.

The current estate and gift tax exemption of $5.12 million will also drop, to $1 million. Currently, the tax on estates valued over $5.12 million is 35%. After the fiscal cliff, a 55% tax rate on estates over $1 million will apply.

In 2010, Congress approved a temporary reduction in the Social Security payroll tax. This 2% reduction took the tax from 6.2% down to 4.2% on the first $110,000 in earnings. This temporary rate is set to expire at the end of the year. This would cost somebody making $50,000 per year an additional $20 per week in taxes.

Although a little year-end tax planning always makes sense, this year it's especially critical because uncertainty about future tax rates. Despite the large unknowns year-end planning is both possible and important; just be prepared to act with little notice.

Capital Gains and Losses

If Congress extends the current 15% capital gains rate into next year and you have any losses in a taxable investment account it could make sense use $3,000 of these losses this year to offset ordinary income, with the excess losses carried forward for use in future years. The assets must be actually sold, and held in taxable accounts, as opposed to IRAs and other tax-sheltered retirement plans.

Capital losses also may be matched dollar-for-dollar against capital gains. For example, if you have $5,000 of long-term losses on some investments, theses losses could be used to eliminate up to $2,000 of capital gains on other investments, after taking the $3,000 deduction against your ordinary income. Beware of the tax code's ‘wash sale’ rule which applies to investment loses; the Internal Revenue Service says a ‘wash sale’ occurs when you sell or trade a stock at a loss and buy the same stock, or something ‘substantially identical’ within 30 days of the sale. (That means within 30 days before or after the sale.) If you violate the rule, you can't deduct your loss.

However, if Congress lets the tax increases go into effect, it may make sense to hold off on taking losses until January, when their value will be greater as they would be offsetting higher income and capital gains tax rates.

Lock in 15% Capital Gains Tax Rate

If you are bullish on an investment with gains, it may make sense to sell it to soak up losses, or to just lock in the 15% capital gains tax rate, especially if rates increase in 2013. Then you can always purchase the identical investment right back as the ‘wash sale’ rule only applies to losses. This may be a wise strategy since the current top capital-gains tax rate of 15% is the lowest in decades. As mentioned you can always buy the investment back which resets the basis in the investment. The only capital at risk would be the commissions you pay on the sell and buy orders, which would be minimal in comparison to potential hundreds or thousands of dollars in tax savings.

Roth IRA Conversions

There are significant benefits to Roth IRAs as contributions and earnings grow tax deferred until needed in retirement, and withdrawals are tax-free once you are in retirement. But remember, the conversion must take place prior to the end of the year in order to take advantage of the potentially lower tax rate in 2012; this may be an especially important point if the 'Bush Tax Cuts' are allowed to expire. Most custodians and brokerage firms are expecting a last minute rush of conversions, so to ensure your conversion gets counted in 2012 it is advisable that you start the process in early December.

Check withholdings

If extra cash would come in handy for the holidays, see if you have had too much withheld from your paycheck for 2012 and make a last-minute adjustment. About three out of four taxpayers received refunds last year, and the average payback was nearly $3,000. That is a considerable sum to park with Uncle Sam interest free.

Charitable Contributions

To qualify for a 2012 deduction, make donations by Dec. 31. The charity doesn't have to have cashed a check or sent you notification by then, but the gift has to be in the mail or otherwise beyond your control by year end. (If you are worried, get proof of mailing.) If tax rates rise next year, should you wait to donate until Jan. 1, when the value of deductions would be greater? It is hard to say, because if rates rise, limits on itemized deductions, phased out during the Bush administration, may return as well. Donations of property such as old clothes or household items must be in "good used condition." Taxpayers who keep total noncash donations to $500 or less don't have to fill out IRS Form 8283. But a donation of a household item worth $500 or more may require an appraisal.

The Road to Serfdom?

Weston Wellington, “Down to the Wire”, Vice President-Dimensional Fund Advisors.

A recent Newsweek cover story proclaimed "We Are All Socialists Now" and observed, "whether we want to admit it or not, America of 2009 is moving toward a European state. . . . As entitlement spending rises over the next decade, we will become even more French."[1]

Newsweek does not clarify their definition of "socialist" or what it means to be "more French"; but for discussion purposes, let us assume that, in the years ahead, government intervention in the US economy assumes a greater role than in the past. What are the implications for investors in US equities?

Based on global equity market results over the past ten years, perhaps very little. Among the 23 developed countries with ten years of MSCI data, the US ranked 20th in US dollar terms, with an annualized return of -1.67%. When results are computed in local currency, the US ranking improves a bit, to 17th. Either way, US stock returns over this period compare unfavorably with countries often characterized by greater government intervention in business affairs.

Were these results an aberration? Using the 39-year period ending in 2008 (the limit of MSCI data) produces a similar overall result: The US ranks 15th among 18 countries in US dollar terms. Sweden ranked 2nd, with a total return of 11,034%, compared to 2,921% in the US.

We are not suggesting that policymakers can enhance US equity returns by implementing a 57% maximum income tax rate, a 25% national sales tax, and mandating a minimum of five weeks of annual vacation for all employees. It seems plausible to us that such an approach, although perhaps politically popular, would likely bring about higher unemployment and weaker economic growth. Researchers have found that high rates of employment and GDP growth offer no assurance of high stock market returns, just as low rates of employment and GDP growth do not predict low stock market returns.[2] If market prices reflect the expected results of government policies, investors are not necessarily disadvantaged.

The degree of government intervention is just one of many factors affecting expected stock returns, and investors should be cautious in assuming it is the principal factor.

Annualized Return (%) 10 Years as of December 31, 2008 In US Dollars		**Annualized Return (%) 39 Years as of December 31, 2008 In US Dollars**	
Canada	8.97	Hong Kong	14.68
Australia	8.36	Sweden	12.84
Norway	8.25	Denmark	12.57
Denmark	6.82	Netherlands	12.16
Singapore	6.48	Switzerland	11.47
Spain	5.04	Belgium	10.72
Hong Kong	4.34	Singapore	10.65
New Zealand	3.62	Norway	10.51
Sweden	3.29	France	10.35
Austria	3.21	Germany	9.90
Finland	2.55	UK	9.87
France	2.36	Spain	9.77
Switzerland	2.10	Japan	9.75
Germany	1.42	Canada	9.43
Japan	0.58	**USA**	**9.12**
Italy	-0.36	Austria	8.69
Netherlands	-0.93	Australia	8.45
Portugal	-1.05	Italy	5.99
UK	-1.05		
USA	-1.67		
Greece	-2.13		
Belgium	-5.69		
Ireland	-9.47		

1) Jon Meacham and Evan Thomas, "We Are All Socialists Now," Newsweek, February 16, 2009.

2) Jim Davis, Economic Growth and Emerging Market Returns, Purely Academic, August 2006.