COROMANDEL WEALTH MANAGEMENT

Income Tax Planning Opportunities in 2012: Analyzing When to Take Deductions and Losses

George Gagliardi, CFP®, MBA

With all the talks of tax changes and the "Fiscal Cliff" approaching, now is a good time for investors to take inventory of their capital loss and gains situation.

With scheduled tax changes for 2013 on the horizon, it makes sense to review your personal situation.

Tax Loss Harvesting

Tax Loss Harvesting has become a strong year-end strategy for tax and financial advisors. In the typical tax loss harvesting situation, an investor has large capital gains from the sale of investments toward the end of a tax year. To avoid capital gains recognition, the investor sells other investments with capital losses to net out the capital gains. If the investor still believes the loss holding is a good investment and only sold it to reap a tax benefit, they must then wait 31 days to avoid the wash-sale rules and repurchase the same investment. On the surface, it appears that the taxpayer has achieved tax savings equal to the reduction in the capital gains tax payable in the current year with no risk. As a result, many financial and tax planners recommend loss harvesting for all their clients with little analysis.

Currently, 2013 income tax rates are scheduled to increase for most taxpayers. The question then becomes when should deductions and losses be taken?

While the general rule of thumb is to accelerate tax deductions and losses, because of the likely tax rate increase, deferring income tax deductions and losses until 2013 might produce more of a tax benefit.

Taxpayers need to take into consideration that it is very likely that the 3% AGI phase-out of itemized deductions could be reinstated in 2013. So what should you do?

Selling or buying investments for tax purposes alone is typically never a prudent strategy. However, using tax rates in the most efficient manner is always a wise decision.

Tax Gains Harvesting

In general, it is typically considered advantageous to delay the realization of capital gains as long as possible. As a result, tax-gains harvesting is often counter-intuitive and less frequently used or discussed. In 2012, under the current tax outlook there are specific circumstances in which tax gains harvesting can be advantageous.

For example:

<u>An investor in the 10% or 15% bracket</u> may choose to claim capital gains in 2012 or earlier, to take advantage of the 0% capital gains rate which is currently scheduled to terminate after 2012.

<u>An investor in a higher tax bracket</u> may choose to claim capital gains in 2012 or earlier, to avoid taxation under the currently-scheduled higher capital gains rates for 2013 and forward.

<u>An investor in the lowest tax bracket</u> (currently 10%) may choose to accelerate capital gains under

the assumption that he/she will be in a higher tax bracket in future years. (Current law affords a lower tax rate to capital gains in the lowest tax bracket even after 2012.)

2012

Ordinary Income Tax Rate	Long Term Capital Gains Tax Rate
10%	0%
15%	0%
25%	15%
28%	15%
33%	15%
35%	15%

2013 and Later Years

Ordinary Income Tax Rate	Long Term Capital Gains Tax Rate
15%	10%/8%*
28%	20%/18%
31%	20%/18%
36%	20%/18%
39.6%	20%/18%

*In 2013, gains on assets held for over 5 years will be taxed at 8% in the 15% ordinary income bracket or below. Gains on assets held for over 5 years with a holding period beginning after December 31, 2000, will be taxed at 18% in higher brackets.

So what could an investor do? Here are two options:

- You can sell assets with long-term capital gains in 2012 to take advantage of low 2012 rates, and repurchase the same or similar assets immediately with no penalty; or
- You can always sell assets whenever you would have sold them otherwise.

Tax Gain Harvesting – Consider Your Time Horizon

The shorter the time period between the gain harvesting sale and the second sale, the more favorable gain harvesting could be. In many situations, the desirability of gain harvesting could decline as the time horizon increases. If the taxpayer harvests gains in 2012, repurchases the investment, and sells in 2013, the taxpayer must be sure to wait for at least a year and a day to obtain a long-term holding period on the subsequent appreciation. The worst possible candidate for gain harvesting would be an older taxpayer in poor health owning stocks with a low basis, who plans to die still owning the stocks, creating a stepped-up basis for his or her heirs. For such a taxpayer, the ROI would be zero because no tax would ever be paid on the pre-death gain. Note that negative returns are possible.

One determination of tax harvesting can be your personal time horizon for owning the investment. Here are some general thoughts based upon that concept:

- **Very short time horizon:**
  - Loss harvesting will almost always be favorable because the benefit of tax deferral is small.
- **Very long time horizon:**
  - Loss harvesting will almost always be unfavorable because the benefit of tax deferral is large.
- **Taxpayer in the 0% long-term capital gains bracket in 2012:**
  - Gain harvesting will always be favorable from a tax perspective because it gives you a free basis step-up.
- **Taxpayer plans to die with assets and pass them on to heirs with a stepped-up basis:**
  - Gain harvesting will most likely be unfavorable, because any gain would have been wiped out at death.
- **Taxpayer has realized loss carryovers from prior years:**
  - Losses would be better used to offset gains in later years when long-term capital gains rates are higher.

Unfortunately, the tax impact can become even worse for those in higher tax brackets in 2013 because of the new **unearned income Medicare contribution tax**. This new tax will affect married couples with $250,000 or more of modified adjusted gross income (MAGI) and single individuals with MAGI of $200,000 or more. While this new tax will only affect those in the highest tax bracket, its impact adds an additional 3.8% of taxation on the lesser of excess income or net investment income.

Here's a quick and simplified example of how the new 3.8% Medicare tax is calculated. Suppose a husband and wife have a combined salary income of $275,000 and investment income of $50,000 from capital gains and dividends. Their MAGI is $325,000 (they have no foreign income or housing exclusions). They owe 3.8% multiplied by the lesser of the excess income over $250,000 (or $75,000) or net investment income of $50,000. Therefore, they owe an additional $1,900 (50,000 x 3.8%) in tax.

Conclusion

What are the risks? The difficult part of your answer is in guessing as to whether bringing taxes forward early and then moving on or potentially reinvesting provides a better long-term solution than the scenario you would generate by extending gains out into a less certain tax environment.

The current Bush tax cuts could be extended, but for how long and for whom is uncertain. Some financial planners are advising their higher income clients to aggressively sell some of their appreciated investments now to lock in the current 15% long-term gains rate, which could move higher in the future, particularly if the Bush tax cuts are not extended again. That's not an unreasonable strategy.

However, you should still do the math for your own situation. The numbers indicate that 2012 gain harvesting could be extremely effective if a taxpayer planned to sell the stock within the next few years, or it could prove to be a poor investment if the taxpayer planned to hold the stock for a long period of time. Any amount you pay in taxes now won't earn a return in future years, and it could be years before the current long-term capital gains rates rise. If, on the other hand, you or one of your family members do qualify for the 0% capital gains rate, you can maximize the benefit of that now.

Tax harvesting could also be far more favorable for a taxpayer with an actively managed portfolio than for one using a buy-and-hold of individual securities strategy.

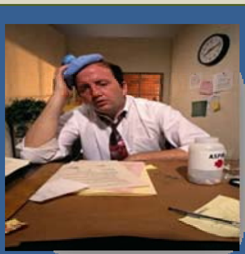
In summary, selling your investments in 2012 could be an effective way to capture long-term capital gains at a lower tax rate compared to waiting. By reviewing your situation you can begin to outline your best strategy. As always, before implementing any strategy, consult your tax advisor to fully understand the tax implications.

If you would like us to review your tax situation before 2013 arrives, please call George Gagliardi at (781) 728-9001 to schedule a complimentary "Financial Check-Up."

George Gagliardi, CFP®, MBA, is a financial planner with Coromandel Wealth Management in Lexington, and helps clients develop and implement retirement, tax, and investment strategies. He is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor, and can be reached at (781) 728-9001 or george@CoromandelWM.com.

Currently, income tax and estate planning tax rates are scheduled to change dramatically in 2013. *Has someone reviewed your investments to see how these changes affect your portfolio?*

Is the tax basis for all of your existing investments listed on your statements?	***Yes***	***No***
Did your investment professional do a full review of your tax forms and show you how your investments are impacting your tax forms?	***Yes***	***No***
Did your investment professional offer you a report on the steps investors can take to reduce their taxes?	***Yes***	***No***
Does your investment professional consider tax consequences and tax alternatives as they make new recommendations?	***Yes***	***No***



If you answered *NO* to any of these questions, then you may not be maximizing your tax strategies and you could be a candidate for a *TAX HEADACHE*!

We would like to invite you to come in for a complimentary consultation to review your investments and how the new tax law changes could affect them in 2013.

To schedule this complimentary consultation, please call George Gagliardi at (781) 728-9001.

Coromandel Wealth Management
15 Muzzey Street
Lexington, MA 02421

Phone: 781.728.9001
info@CoromandelWealthMgmt.com
www.CoromandelWealthMgmt.com

Advisory services offered by Trust Advisory Group, Ltd., a Registered Investment Advisor
444 Washington Street, Suite 407 • Woburn, MA 01801 • (781) 933-6100