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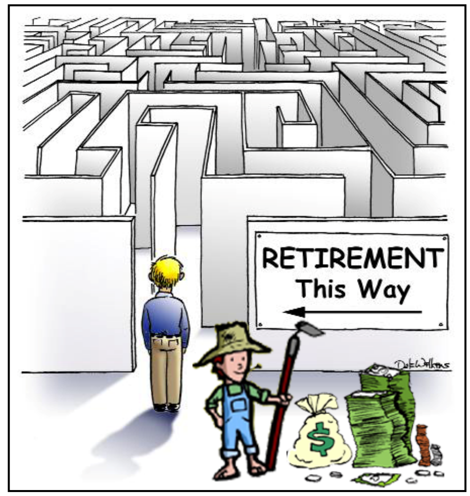
Time to Harvest Your Gains

Navigating the Retirement Maze



Tax-aware investors know that the end of the calendar year is the time to take an inventory of taxable portfolios, looking for losing investments that can be sold in order to offset the gains of their winners, plus up to $3,000 of ordinary income. This year, though, there's another tax issue to consider. High income families (over $250,000 in modified adjusted gross income for joint filers; over $200,000 for single filers) will be hit with a 3.8% surtax on realized investment gains starting in 2013. Plus, if Congress fails to extend the Bush tax cuts through 2013, then nearly all taxpayers will be paying higher capital gains taxes next year.

So in the absence of any legislative extensions by Congress, your Federal tax bill will most likely increase in 2013, and those in the high income category will pay more in either scenario. Fortunately, there are a few actions that you can take this year to reduce your 2013 tax bill, and not have to part with those funds or stocks that you want to keep in your portfolio.

The Tax Man Cometh

The so-called Bush tax cuts are scheduled to expire at the end of this year. If Congress doesn't extend them, the impact on investment gains in 2013 will be substantial. Taxes on long term capital gains will increase from 0% for those in the bottom two tax brackets and 15% in all others, to 10% and 20%, respectively, plus a 3.8% surtax for those with high incomes. Dividends will be hit even harder. Right now, qualified dividend income is tax-free for those in the bottom two tax brackets, and 15% for higher brackets. Absent an extension, qualified dividends will be taxed as ordinary income in 2013, with the top tax rate increasing from 15% to 43.4% (39.6% + 3.8% surtax).

Financial advisors usually caution against making investment decisions based solely on tax considerations. However, your investment strategy should definitely take into account tax consequences, because it's what you keep after taxes are paid that counts. It's practically a given that there will be changes to the tax laws over the next two years, and even more likely that high income families will see their tax bills increase. Thus, it makes sense to start looking at ways to mitigate some of the impact of tax reform while you still have time.

Grab Those Gains Now

If you're holding securities or funds in taxable accounts that have appreciated significantly and you've owned them for over a year, now might be a good time to book those gains. Those in a high income bracket will be paying at least 3.8% more in taxes on the appreciation if they wait to sell until next year, and even more if the Bush tax cuts don't get extended. But what about investments that you want to hold on to? Say you're not quite ready to part with those shares of Apple Computer that you bought at 40. You can still cut your future tax bill by "harvesting gains."

When you sell a stock to realize a tax loss, you aren't allowed to buy back the same stock for 31 days or else you lose the deductibility of the loss, also known as the "wash sale rule." However, there is no such restriction on realizing gains. You can sell appreciated securities today, and buy them back five minutes later. You'll pay tax on the appreciation this year at the lower rate, and reset the cost basis of the security to the price at which you repurchase it. Note that this may not be an economical strategy if you plan on holding the stock an additional five years or more, or if you are carrying over realized capital losses from previous years.

More to Come

Once the 2012 election is over, expect to see a lot happening on the tax front over the next two years. What the "lame duck" session of Congress does – or doesn't do – this year will affect which tax moves you should consider before year-end. With tax reform on the agenda of both Congress and the White House, 2013 will be a crucial time for reexamining your estate planning, investment, and tax strategies in order to minimize the tax impact of legislative changes. Stay tuned. There's much more to come.

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