The Carnegie Counselor

THE CARNEGIE INVESTMENT COUNSEL NEWSLETTER THIRD QUARTER 2012

Saving Cinderella

Similar to the fairy tale princess Cinderella, whose carriage will turn back into a pumpkin at midnight, our economy is facing a looming deadline at year-end.

Our eminent leaders inWashington, D.C. have deferred making tough decisions and most major tax policies are scheduled to increase at the end of 2012. This places most Americans in an economic quandary when making decisions on investments, taxes, gifting, retirement or estates. Not knowing the rules creates a stagnant environment riddled with poor planning. Taxes impacting your estate, your investments and your income will be changed at the toll of midnight on New Year's Eve unless Congress acts. So far, there does not appear to be a Prince Charming on the horizon capable of saving our Cinderella tax rates.

For the past eleven years, the rules concerning the federal estate tax have been in a constant state of change. During this period, the amount an individual can pass free of estate tax has increased from $1 million, to $2 million, to $3.5 million, (to an unlimited amount in 2010) and currently stands at $5.12 million. Without Congressional action, the current estate tax exemption is slated to automatically revert to $1 million on January 1st. This number is indexed to inflation since 2001 and is estimated to be $1,430,000 for 2013. In addition to this drop, the federal estate tax rate will increase from the current 35% to a much larger 55% tax on all estates. These new rates were planned to start in 2011; however, on December 17, 2010 Congress pushed these rates back two years to give them more time to permanently fix the problem. Two years later nothing has been accomplished, so we are "inheriting" the estate taxes planned for 2011.

Presently the tax rates on capital gains and dividends are 15%. While this is often considered a form of "double taxation" since taxes have already been paid on these assets at the company level, this rate is also going up in 2013. The capital gain tax on long-term gains will be increased to 20%, and for the first time in history, capital gains and dividends (unearned income) will be subject to Medicare taxes as part of the Affordable Care Act of 2010. This 3.8% tax is in addition to regular income taxes and subject to a certain threshold of income. Finally, all dividends

In the news

Carnegie was proud to sponsor Dr. Arthur Laffer, Economist through the Cleveland CFA Society. Dr. Laffer has been widely acknowledged for his economic achievements. He was noted as one of "The Century's Best Minds" for inventing the Laffer Curve. Dr. Laffer gave a dynamic speech about fiscal policy, comparing and contrasting both now and in the past and its impact on our modern day economy. Thank you Dr. Laffer.

will be subject to ordinary income tax rates instead of the current 15% rate. Therefore, if you are in a high tax bracket, the tax on your dividends will increase over 160% just on the federal level (state taxes are in addition) to a maximum rate of 39.6%.

The Bush-era tax cuts are set to expire and this will increase tax rates at all income levels. The highest rate will go from 35% to the aforementioned 39.6%. It is estimated by Bloomberg News that the average federal tax rate will reach 24.3%, up 5 percentage points from the present level. Low-income households have the most at stake in expiring expansions of the child tax credit, level of exempt earnings from taxes and the earned income tax credit. After the elections next month, Congress is scheduled to return to Washington to debate the automatic spending cuts and the tax increases that will start in January if lawmakers don't act. The increase in taxes would be over $500 billion, or about 20%, so the incentive to take action might not be present. The estimated spending cuts will impact the Department of Defense the greatest, and the new taxes are needed to reduce the deficit. Both Democrats and Republicans have something to gain if nothing is done, so expecting inaction might be the best option for your financial planning.

A weak U.S. economy that has been supported by strong U.S. domestic spending could be hurt further if dramatic federal spending cuts occur. Corporations are sitting idly by with large coffers of cash unwilling to make major capital investments until future tax rates are clarified. Instead of creating an environment to improve the economy, our federal legislature has pursued their personal interests akin to Cinderella's stepsisters.

How should we then position investments while we approach this fiscal cliff?

- The IRA Charitable Deduction- One glimmer of hope is that it looks promising that Congress will again allow a direct payment to charity out of your IRA if you are over 59 ½.
- Consider taking capital gains in 2012 if it looks like rates will increase.
- Accelerate gifting to take advantage of the enhanced lifetime exemption.
- Take higher IRA withdrawals or consider a Roth IRA conversion.
- Defer itemized state and property taxes into 2013.

The issues surrounding these planning steps are complex. A coordinated effort with your tax advisor is highly recommended.

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Many investors have done quite well by operating on a philosophy that says the future is uncertain and you should never pay any tax until you absolutely must. Our investment policies have a stipulation that investment decisions are a priority over tax decisions and this discipline has served us well. This year, though, as the clock nears midnight, when positioning your portfolio for 2013, we want to keep you in the carriage you are accustomed to and not leave a glass slipper behind due to taxes.

As a truly independent investment management and planning firm, Carnegie Investment Counsel has a rich history of providing careful and responsible management of your financial assets to reach your short and long-term goals.

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