

Tax Strategies

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U.S. Fiscal Uncertainty and Your Portfolio

The fiscal cliff loomed as we sent this issue to the printer three weeks before the November election. Unless Congress and the president reach an agreement, tax cuts enacted under the George W. Bush administration will expire and automatic budget cuts will go into effect on January 1, 2013. As I said in my Editor's Note, we are delaying publication of our 2012 tax guide until the January 2013 issue in hopes that we will have more clarity about 2013 tax rates.

Congress is expected to reconvene on November 13. It is possible that both parties will agree on a plan or at least be close to agreeing on a plan by the time you read this. It is also possible that no agreement will have been reached and fiscal uncertainty will still loom. Either way, there are portfolio actions you can and should not take heading into the new year.

Use the tax status of your accounts to your advantage

If you have an individual retirement account (IRA) or a Roth IRA, use them for your less tax-efficient investments and strategies. Capital gains, dividends and corporate bond interest payments are not taxable events when they occur in an IRA or a Roth IRA. (You will pay taxes on amounts withdrawn from a traditional IRA, however.)

Use your taxable brokerage accounts for your most tax-efficient investments, such as index funds and municipal bonds.

Consider the tax advantages of municipal bonds

Not only is interest earned from municipal bonds generally exempt from federal taxes, it may also be exempt from state and local taxes. (Check the tax laws for where you live.) Plus, interest earned from municipal bonds is excluded from the new Medicare tax scheduled to go into effect next year.

Fears about widespread municipal bond defaults are overblown but, like any asset, you should analyze the risk characteristics of the specific bond you are considering.

Don't fear dividend stocks

If no resolution is reached, tax rates on qualified dividends will rise to ordinary income levels. If this does occur, there are reasons to believe dividend stocks should not specifically be adversely affected. First, more than 80% of the S&P 500 companies now pay a dividend, so any aversion to dividend stocks will impact the entire market. Second, many dividend stock investors are either institutional investors (pension funds, endowments, etc.) or individual investors holding these stocks in an IRA. Neither group will be impacted by the higher tax rates. Third, analyses of the 2003 tax cuts suggest a weak link, if any, between tax rates and the performance of dividend-paying stocks. Finally, if the fiscal cliff occurs, the impact will reach far beyond dividend stocks.

Estimate your 2012 tax bill

Tax rates, with the exception of the alternative minimum tax (legislation for a patch to the 2012 AMT has yet to be passed by Congress), for this calendar year are known. Use the known rates to estimate how much you will owe. Then, look at forthcoming taxable events. While we do not advocate letting taxes determine your investment decisions, if there are profits or losses you intend to realize this year or next, regardless of what Congress does, you may want to take the timing into account. Depending on your tax situation, it may make more sense to realize those events this year or delay them until next year. A tax professional may be able to help with this decision.

Diversify your investments

Any deficit reduction plan will make cuts to government spending and adjustments to tax rates. Rather than trying to guess who winners and losers will be, hold a variety of investments, including stocks from a mixture of industries and sectors.

Contact your representative and senators

Their job is to represent your interests, so don't hesitate to speak up.