



# Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

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## New Law Poses Tax Risks For High-Income Investors

It will take time for investors to absorb exactly what happened—and what did *not* happen—in the new tax law enacted to avert the “fiscal cliff.” Under the new law, called the American Taxpayer Relief Act (ATRA), favorable tax rates on different types of investment income generally were preserved, but certain upper-income investors will face tax increases, beginning in 2013.

When you combine the ATRA changes with the new 3.8% Medicare surtax—also making its debut in 2013—you could be hit with a rate as high as 43.4% on a portion of your investment income.

Consider the following three main new tax law provisions:

**1. Ordinary income.** The existing federal income tax rate structure—with rates of 10%, 15%, 25%, 28%, 33%, and 35%—continues for most taxpayers. But ATRA adds a new top tax of 39.6% for single filers with income of more than \$400,000 and joint filers with income above \$450,000. That means that a short-term capital gain on the sale of a stock you’ve owned for a year or less—a profit taxed at ordinary income rates—could trigger the 39.6% federal rate.

**2. Capital gains and qualified dividends.** Under ATRA, the maximum tax rate for net long-term capital gains and qualified dividends remains 15% (0% for investors in the lowest tax bracket). If the law hadn’t passed, the tax rate for capital gains would have soared to 20% (10% for investors in the

lowest tax bracket), and dividends were scheduled to be taxed at ordinary income rates. Despite the reprieve for most investors, however, those who exceed those same high-income

thresholds—\$400,000 for single filers and \$450,000 for joint filers—now will pay a maximum 20% tax rate on long-term capital gains and qualified dividends.

**3. Medicare surtax.** This “add-on” tax actually was included in the 2010 health care legislation—the Patient Protection and Affordable Care Act—rather than ATRA.

But it also takes effect in 2013, and it can be just as lethal to upper-income investors as some ATRA changes. A 3.8% Medicare surtax now will apply to the lesser of “net investment income” (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount—\$200,000 for single filers and \$250,000 for joint filers. These figures will not be indexed for inflation.

For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. Certain items are excluded from the NII definition, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans and IRAs.

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## Profile Of An RIA Working Only For You

Investors want a relationship with a financial advisor where they know they both are working towards the same goal and that the advisor is making investment decisions with their clients’ best interests in mind. Investors must choose an advisor based on many personal factors, and the options can be confusing. RIA? Broker-Dealer? Manage Yourself?

As a fee-only Registered Investment Advisory firm (RIA), our primary function is to provide personalized, focused financial advice and our clients have chosen to work with us for a number of very important reasons. They want a financial advisor that has a fiduciary responsibility to put their interests first, understands their specific financial situation, offers straightforward advice that reflects their long-term goals, recommends investment solutions that best fit their unique needs, and uses a fee-only structure that encourages unbiased advice. Similarly important, we are one of only a handful of RIAs in the Des Moines area approved to use institutional funds from Dimensional Fund Advisors (DFA) in our client portfolios. DFA Funds provide global investment solutions with state-of-the-art portfolio design and trading, and are not available to the general public.

The 2013 update of our Registered Investment Advisor Disclosure Brochure is now available, which highlights the qualifications and business practices of our fee-only investment advisory services. Please contact us for a copy.

Please note: our business hours are 8:00am to 4:00pm Monday-Thursday and 8:00am to 3:00pm on Fridays now through December.

Steven L. Kane, CPA/PFS, CFP®



# Roundup Of New Estate Tax Changes

**F**or more than a decade, estate planning has harkened back to the “wild, wild west,” a time when even the best hired guns didn’t know what would happen next. Now, finally, there’s more certainty, thanks to the estate tax provisions in the American Taxpayer Relief Act (ATRA). The new law, signed as the country teetered on the brink of the “fiscal cliff,” extends several favorable tax breaks, with a few modifications.

Before we explore ATRA’s main provisions, let’s recap the events dating back to 2001, the year the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted. Among the changes, EGTRRA gradually increased the federal estate tax exemption from \$1 million to \$3.5 million in 2009 while decreasing the top estate tax rate from 55% to 45%. It also severed the unified estate and gift tax systems, creating a lifetime gift exemption of \$1 million unrelated to the estate tax exemption. Then the law repealed the estate tax completely, but just for 2010. After that year, the estate tax provisions were scheduled to “sunset,” restoring more onerous rules that had been in effect before

EGTRRA, unless new legislation dictated otherwise.

The Tax Relief Act of 2010 generally postponed the sunset for two years. It hiked the estate tax exemption to \$5 million (indexed for inflation), lowered the top estate tax rate to 35%, and reunified the estate and gift tax systems. That law also allowed “portability” of exemptions between spouses.



Now, at long last, ATRA brings permanent clarity. Here are the key estate changes:

- The estate tax exemption remains at \$5 million with inflation indexing. For 2013, the exemption is \$5.25 million. Also, portability of exemptions between spouses is

made permanent, so a married couple can effectively pass up to \$10.5 million tax-free to their children or other non-spouse beneficiaries, even if the exemption of the first spouse to die isn’t exhausted.

- The top estate tax rate is bumped up to 40%. Not as low as the 35% rate in 2011 and 2012, but still better than the 55% rate slated for 2013 prior to ATRA.
- The estate and gift tax systems remain reunified. This means that the lifetime gift tax exemption is equal to the estate tax exemption of \$5.25 million in 2013. (That’s now the maximum exemption for combined taxable lifetime gifts and estate bequests.) Other provisions, including the generation-skipping tax that applies to most bequests and gifts to grandchildren, are coordinated within the system.

As a result of these changes, now is a good time to examine wills, trusts, and other aspects of your estate plan. Depending on your situation, revisions may be required or you might create a new trust to take advantage of the current estate tax law. ●

## Find Tax Alpha In New Equation

**F**inancial planners often talk about finding “alpha” for their clients. In technical terms, alpha is the amount by which a portfolio’s return exceeds that of a benchmark, such as Standard & Poor’s 500 stock index. Considering how much the overall stock market has risen recently, finding alpha is a difficult task. Still, there’s another, related objective—tax alpha—that might be within reach.

Tax alpha is the amount by which, through strategic management, the after-tax returns of a portfolio exceed those of a benchmark. The typical strategy for doing that is to reduce the tax you owe on gains from

securities sales by selling depreciated stocks and using the losses to offset the taxable gains.

Your ability to find tax alpha could be affected by the tax changes in the American Taxpayer Relief Act (ATRA). Under the new law, long-term capital gains continue to be taxed at a maximum 15% rate for most investors (0% for those in the two lowest income tax brackets), but the maximum rate is boosted to 20% for single filers who have taxable income of more than \$400,000 and joint filers above \$450,000. These new tax rules took effect at the beginning of 2013. Still, even upper-income investors can

continue to use capital losses to offset capital gains, plus up to \$3,000 of ordinary income. (Any remaining loss can be carried over to next year.)

Traditionally, investors have waited until the end of the year to harvest tax losses, when they have a good idea of their overall tax picture. But that approach is effective only if you have actual losses to recoup. Thanks to recent market gains, there could be fewer opportunities than usual in December. So it could make sense to realize losses as they occur—for instance, if a market correction depresses prices and gives you a chance to sell some holdings at a loss.

# Strategists Miss Again on Sector Predictions

What's the one thing most Wall Street analysts' annual market predictions have in common? They're almost invariably wrong. Yet many investors continue to follow these gurus year after year in hopes of gaining an investing edge.

The year 2012 was no different, according to economist Fritz Meyer, who has been tracking Wall Street predictions since 2005. "The top analysts have failed to add any return over that time," Meyer says in a blunt assessment. "There is not one year in which, on balance, the strategists did well. They have consistently fallen far short

of being able to beat the Standard & Poor's 500 with their sector calls." In fact, Meyer asserts, investors might prosper by taking a contrarian view. "If you bet against the consensus every year you probably will come out well."

The lesson is to stick with modern portfolio theory (MPT), which dictates diversification and periodic rebalancing of your portfolio based on your goals and risk tolerance. Some investors believe the 2008 financial crisis dealt a blow to MPT, but Meyer says the opposite is true: Investors who continued to diversify and rebalance their portfolios had

comparatively good results.

He adds that "tactical asset allocation," often offered as an alternative to MPT, is based on the premise that you can guess which sectors are going to outperform, and shift your holdings accordingly. "It gained a lot of currency after the bear market, when a lot of people concluded that modern portfolio theory was dead," Meyer says. "That wasn't true. Had you followed MPT you would have come out the other end smelling like a rose." The problem, he says, is that investors failed to diversify and rebalance their portfolios as the crisis unfolded.

Each year, Meyer looks at the *Barron's* Forecast, which includes sector picks from 10 top Wall Street analysts. Their predictions for 2012, published in *Barron's* in December 2011, followed the usual pattern, with most turning out to be wrong or very wrong. (See table.)

The gurus' worst call was in financials. Six analysts predicted financial stocks would underperform the S&P 500, while just one thought they would do better than the index. In fact, financials returned a whopping 26%, almost double the 13.4% return of the S&P.

And although three analysts gave consumer discretionary stocks an "outperform" rating, three others predicted "underperform," missing the mark for a sector that returned 22%.

Continuing a pattern from previous years, nine analysts gave thumbs up to the information technology sector, which turned in a respectable performance at 13%, though that still trailed the S&P by a hair. The one good call was on utilities, which three analysts rightly gave thumbs down—it lost 3%.

"These strategists are being asked to do an impossible job," Meyer says. It has long proven impossible to predict consistently which sectors will outperform or whether growth stocks will outdo value stocks, small caps will beat large caps, or dividend-paying stocks will outperform those that don't make payouts to shareholders, he notes. Even when an analyst gets it right one year, the next year's guess is likely to be wrong. For investors, Meyer says, it's much better to stick with the tenets—and the track record—of modern portfolio theory. ●

## Investment Strategy

### Wall Street's Calls for 2012 – some big mistakes

Barron's 2012 Forecast<sup>1</sup>

Survey of 10 stock market strategists' sector picks and pans for 2012

	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Telecom Services	Utilities
Federated	+	-	+	-		+	+	+		-
Blackrock				-	+		+			
Barclays Capital		-	+	-	+		+	-		-
Putnam				-2		+	+			
Goldman Sachs	-	+				-	+	-	+	
JPMorgan	+	-		+	+	+	+	+	-	-
Citibank	-	+				-	+		+	
Morgan Stanley	-	+			+	-				+
Prudential	+			-		+	+	-		
BofA Merrill Lynch		+		-			+	-		
Net (+/-)	0	+1	+2	-5	+4	+1	+9	-2	+1	-2
Actual 2012 Sector Returns (Rank)	+22% (2)	+8% (8)	+2% (9)	+26% (1)	+15% (3)	+12% (6)	+13% (4)	+12% (7)	+13% (5)	-3% (10)
	Big Miss	Mistake	Mistake	Huge Miss	OK call	Mistake	Mistake	OK call		Good call

<sup>1</sup> Published Dec. 19, 2011.

<sup>2</sup> Big money center financials.

<sup>3</sup> The S&P 500 price index gained +13.4% in 2012; the S&P 500 Total Return index gained +16.0%.

Most-panned and second largest sector was, by far, the best performer in 2012.

Making the right decisions about what to sell and when to take losses can get complicated, however. One approach compares existing investments to model portfolios to produce a "target portfolio." Using tools that can compare digital overlays of different portfolios, this can identify potential trades that will maximize tax losses. At the same time, this method aims to replace securities sold at a loss with other holdings that make sense in terms of the management goals for your

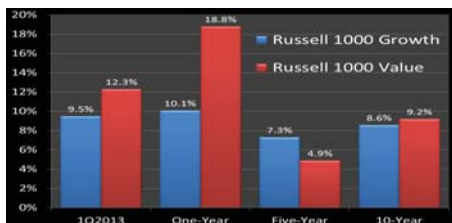


portfolio. This can result in a target portfolio that's as diversified as your original portfolio but that has more potential for alpha—particularly that holy grail of tax alpha.

Of course, the quest for tax alpha shouldn't happen in isolation. Other variables, including your tolerance for risk and the suitability of particular investments for your situation, also will affect your investment strategies and decisions. We can help you find an approach that fits your circumstances. ●

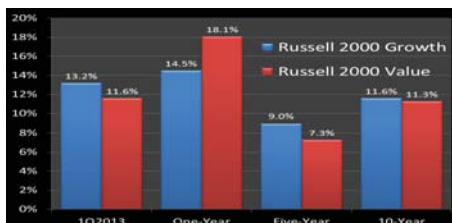


# Market Data Bank: 1st Quarter 2013 \*



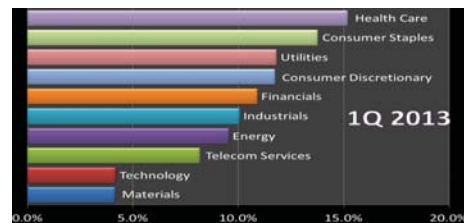
## LARGE VALUE VS. LARGE GROWTH

1Q2013 was again a strong quarter for U.S. stocks. Stocks in the quarter returned what bulls hope for in a full year. The five-year total return shown encompasses the financial-crisis bear market and recovery through 1Q2013.



## SMALL VALUE VS. SMALL GROWTH

Small-cap growth companies in the Russell 2000 index showed total return of 13.2% in 1Q2013, as the U.S. stock rally continued to confound skeptics. Bulls said a "great rotation" from bonds to stocks was under way.



## LARGE-CAP STOCKS BY INDUSTRY

Tech companies, while a fascination, last quarter were among the weakest of the 10 industry indexes of S&P 500 companies. Consumer stocks were among top sectors; reflecting a recovery in consumer balance sheets.



## ASSET CLASSES \*

Of 11 asset classes, commodities were by far the worst for the five years ended 3/31/2013, highlighting the risk of betting on any one asset class. The best asset class, as represented by these 11 stock and bond ETFs and indexes, was gold, which lost luster last quarter.



## S&P 500 INDEX VS. EARNINGS \*

Estimated S&P 500 earnings per share as of March 21, 2013 was \$112.21 for 2013 and \$125.31 for 2014. If consumer spending holds and companies meet expectations, the trajectory of stock prices versus earnings is shown in the red squares in the chart above.



## FOREIGN STOCK MARKETS

U.S. stocks outperformed stock markets of foreign regions across the world for the five years ended 3/31/2013. The period encompasses a bear market in 2008 and recovery through 1Q2013. The U.S. economy did show resilience versus foreign markets in the period.

\* Past performance does not indicate future results. \*Indices and ETFs representing asset classes are unmanaged and not recommendations for any specific investment. Foreign investing involves special risks, including political or economic instability and currency fluctuation. Bonds offer a fixed rate of return while stocks fluctuate. \*Actual S&P 500 index data through 3/31/2013 and actual earnings through 12/31/2012. Estimated 2013 and 2014 S&P 500 earnings per share as of March 21, 2013. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates; Standard and Poor's for index prices through 3/28/13 and actual earnings.

## New Law Poses Tax Risks

(Continued from page 1)

Now let's see how these tax changes might affect taxes on investment income:

**Example 1.** You're a joint filer with an annual MAGI of \$170,000 consisting mainly of wages. This puts you in the regular 28% tax bracket. At the end of the year, you realize short-term capital gains of \$10,000 and long-term capital gains of \$40,000, for a total of \$50,000 in NII. Because you don't exceed the threshold for ordinary income, your short-term gains still are taxed at the 28% rate. And you don't exceed the threshold for capital gains either, so your long-term gains are taxed at the 15% rate. Finally, the lesser of your NII or excess MAGI is zero, so

you don't have to pay the 3.8% Medicare surtax.

**Example 2.** You're a single filer with an annual MAGI of \$500,000, consisting mainly of wages. This puts you in the new top tax bracket of 39.6%. At the end of the year, you realize short-term capital gains of \$25,000 and long-term capital gains of \$75,000, for a total of \$100,000 in NII. Your short-term gains are taxed as ordinary income at the 39.6% rate. In addition, you exceed the threshold for capital gains, so your long-term gains are taxed at the 20% rate. Finally, the lesser of your NII or excess MAGI is \$100,000, triggering



a Medicare surtax of \$3,800 on top of your other taxes.

Accordingly, the new tax rules could affect the rates you pay on investment income. And while taxes alone never should determine your investment decisions, it makes sense to factor them in when you're considering what and when to buy or sell. Depending on your situation, you might accelerate income or capital gains into the current year to avoid higher taxes next year, or you could postpone income or gains to next year to avoid higher taxes this year. We can work with your tax advisor to help you decide what makes sense in your situation. ●