FERRELL
WEALTH MANAGEMENT INC.
Registered Investment Advisor

WEALTH MANAGEMENT NEWSLETTER

Harvesting Capital Gains Reaps New Rewards In 2013

Traditionally, investors try to "harvest" capital losses at the end of the year to offset gains realized earlier in the year. But there's a new twist to tax planning for 2013.

If you sell stock at a loss in 2013, that loss generally can be used to offset taxes on capital gains of up to the same amount, plus as much as $3,000 of ordinary income, which is taxed more heavily. A loss could offset tax on a gain dollar for dollar. And, if you have more losses than you can apply than gains, you can carry them over to reduce your gains taxes next year. This is a central strategy in yearend tax planning for investors, and depending on your situation, harvesting capital losses to offset gains still may make perfect sense in 2013.

However, due to changes in tax laws, your focus might shift to the other side of the equation: harvesting capital gains in the current tax year. Those gains might let you take advantage of losses you've realized during the year, or they could be advisable for other reasons. To understand this shift in emphasis, consider the rules for how capital gains are now taxed.

Prior to 2013, the maximum tax rate on long-term capital gains for investors was 15% (and 0% for those in the regular 10% and 15% income tax brackets). Long-term gains come from the sale of capital property, such as securities and real estate held more than a year. However, under the American Taxpayer Relief Act (ATRA), the maximum tax rate for capital gains increases to 20% joint filers with taxable income above $450,000. (For other taxpayers, long-term gains still are taxed at either 15% or 0%.)

Meanwhile, the tax for ordinary income, such as salary, bonuses, and other compensation, is based on a graduated rate structure. Before 2013, the top tax rate was 35%, but ATRA added a higher bracket of 39.6% for taxpayers whose income exceeds the same income thresholds as those for long-term capital gains. Short-term capital gains, from the sale of capital property held for a year or less, are taxed at ordinary income rates and could be subject to the new top rate.

To further complicate matters, a 3.8% Medicare surtax now applies to the lesser of "net investment income" or the amount of your modified adjusted gross income (MAGI)

(Continued on page 4)

Looking Good!

Through September, the S&P 500 delivered a year-to-date return of 19.8% and looked to be on track for its strongest year since 2009. Developed markets outside the U.S. also posted double-digit year-to-date gains, and emerging markets experienced a nice bounce as well.

The uneasiness in the markets due to the taper talk, the increase in mortgage rates and the unrest in Syria seemed to dissipate upon the Fed's decision to forestall the taper. Then came the government shutdown.

Despite the volatility and the issues at hand, our outlook remains positive. Corporate balance sheets are healthy, and record high corporate cash levels could help fund new job growth and capital expenditures. Consumer debt has returned to near the levels of the 1990s, consumer confidence has risen, auto sales have accelerated, and lean inventories have boosted home values. Even with a rise in mortgage rates, housing is beginning to recover.

While we watch and analyze carefully what transpires in the market, we continue to believe a diversified portfolio is the key to navigating the bumps along the road to reaching your long-term financial objectives.

Please don't hesitate to contact us with your questions and concerns; we value your relationship and appreciate the confidence you've placed in our ability to lead you through the market cycles.

Warmest regards,

James W. Ferrell,
MBA, CPA, PFS, CIMC, CFP, President

Managing Your Tax Bracket Now Crucial

Four tax law changes that took effect in 2013 are driving high-income earners to manage their tax brackets more carefully.

1. A new top income tax rate for ordinary income of 39.6% (previously 35%) has been added for single filers with taxable income above $400,000 and joint filers above $450,000.

2. For investors who exceed those same thresholds, the maximum tax rate on long-term capital gain has increased from 15% to 20%.

3. A new 3.8% surtax applies to the lesser of "net investment income" (NII) or the amount by which modified adjusted gross income exceeds $200,000 for single filers and $250,000 for joint filers. The definition of NII includes capital gains and dividends, but not payouts from retirement plans and IRAs.

4. The tax benefits available for itemized deductions and personal exemptions are phased out for taxpayers above certain income limits.

Faced with this changing tax landscape, you need to be especially vigilant to keep "bracket creep" in check. At the same time, it could make sense to realize year-end income up to the next bracket threshold. Here are several tax strategies to consider in this environment:

• Make the most of your capital gains and losses. If you've taken losses during the year, it could make sense to realize capital gains now, using those losses to offset extra income that could put you in a higher bracket or subject you to the 3.8% surtax. Or, if you have existing gains, taking capital losses could offset them and up to $3,000 of ordinary income.

• Convert a traditional IRA to a Roth IRA—but stagger the amount you convert each year to avoid rising into a higher tax bracket. The converted amount is taxable as ordinary income, but it may pay off in the form of future tax-free distributions.

• Stay in a lower bracket by shifting taxable income to the younger generation. For instance, you might give dividend-paying stock to a child in a low tax bracket. Just keep in mind that under the "kiddie tax," unearned income above $2,000 received by a dependent child in 2013 generally will be taxed at your top rate.

• Reduce your taxable income by making charitable gifts. The tax law generally allows you to deduct the fair market value of donated property that you've held for more than a year. However, deductions for charitable gifts are among those that may be reduced for upper-income taxpayers. ●

Want To Shift Income? Give It Away

With three key tax provisions that took effect in 2013 raising the ante for high-income earners, you may be inclined to look for ways to shift income-producing assets to family members in lower tax brackets. That can be effective, as long as you're comfortable with the trade-offs.

By now, you know about the tax changes affecting those in upper-income brackets. There's a higher top rate for income—now 39.6%, up from 35%, which applies to single tax filers with income above $400,000 and joint filers above $450,000. There also has been a tax hike on capital gains and qualified dividends, with the usual maximum 15% rate for long-term capital gains and qualified dividends jumping to 20% for tax filers above those same income thresholds. And, finally, there's the Medicare surtax, a new 3.8% tax that applies to the lesser of net investment income or the amount by which your modified adjusted gross income exceeds $200,000 for single filers and $250,000 for joint filers.

What is the end result? If you earn enough, you might be forced to pay a combined 43.4% tax rate on some of your income, and that doesn't even count additional state or local income taxes.

To lighten this heavier tax load, there are several possibilities, including sophisticated trust arrangements. But by far the simplest—and potentially one of the most effective—ways to shift income is to give outright gifts to your children or to other low-taxed family members. Not only will the earnings from property you give away be taxed to your offspring—instead of to you in your higher tax bracket—but you also may be able to reduce or eliminate the 3.8% Medicare surtax.

Suppose you're in that combined 43.4% tax bracket and you shift $10,000 of annual taxable income to

5-Year Results Show Diversification Is Key

The term diversification is used so often in marketing investment products that it's easy to take for granted. Yet it is crucial to investment success and diversifying a portfolio correctly is not so simple.

The accompanying bar chart analyzes segments of the U.S. stock market by divvying up U.S. publicly-held companies based on valuation and market capitalization. Look at how small- and mid-cap companies dramatically outran returns from large-cap companies represented by the Standard and Poor's 500 Growth and S&P 500 Value Index.

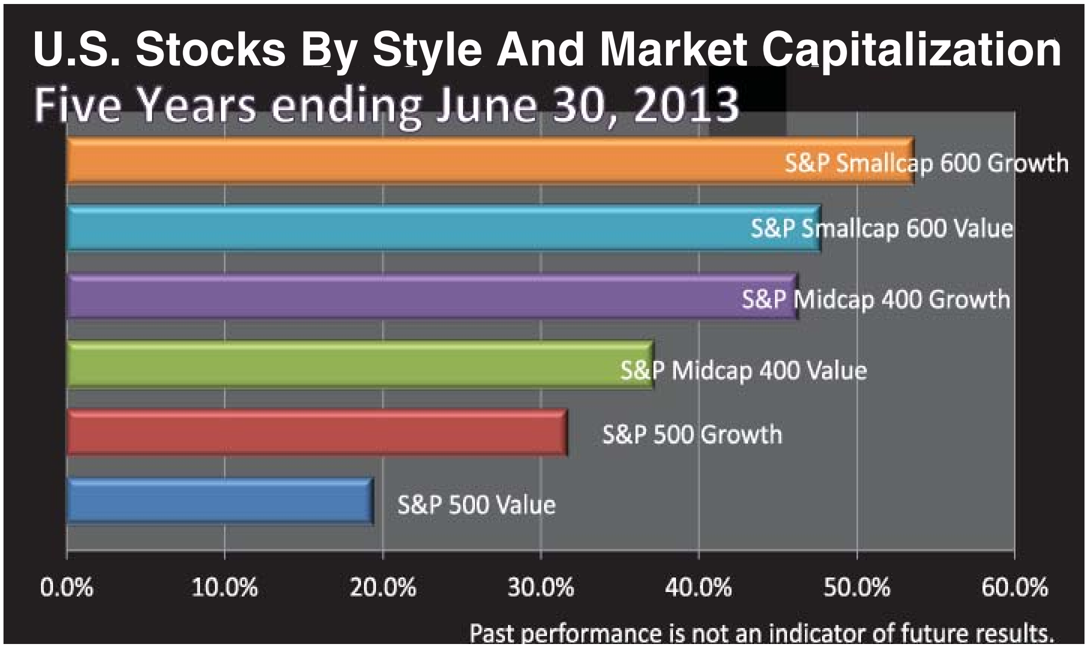
This chart covers the five-year period that ended June 30, 2013, but such differences in performance among different segments of the market are not uncommon. In some five-year periods, large-cap growth companies outperform while small-cap companies or mid-caps might outperform in other five-year periods.

Because no one can reliably predict which market segment will outperform another, it's wise to avoid making bets on a single segment of the stock market. Put another way, it's wise to diversify. But what exactly does that mean?

Diversification of investments is widely defined as not putting all your eggs in one basket. The egg analogy is something anyone can understand. But diversifying is not as simple as buying a lot of different investments.

To diversify investments, it's prudent to apply the statistical analysis prescribed in the Nobel prize winning academic work that forms the basis of Modern Portfolio Theory, or MPT.

Modern Portfolio Theory Statistics are based on the Capital Asset Pricing Model (CAPM) of expected returns, which Nobel laureate William Sharpe is credited with developing in the early 1960s. CAPM (pronounced CAP –EM) was based on the modern portfolio theory first written about in the 1950s by Sharpe's one-time professor, Harry Markowitz. Markowitz and Sharpe shared the Alfred Nobel Memorial Prize in Economic Sciences in 1990 for their work on MPT.



MPT provides a method for analyzing market trends based on measurable characteristics in portfolios, such as standard deviation, which measures volatility, and R-squared, which measures correlation of one market segment to another.

By applying Modern Portfolio Theory, you are able to rebalance and manage your wealth using an organized system of statistical analysis. You are able to measure correlation coefficients to understand how adding an investment to your portfolio has affected a portfolio like yours in the past. You are able to model the future and how your portfolio might behave through different financial and economic cycles. ●

each of three children in the 25% tax bracket and two grandchildren in the 15% bracket. You'll save a total of $11,200 in taxes, this year, next year, and every year until the rules change again. (You will, however, have to watch out for the "kiddie tax," which calls for unearned income above a threshold—$2,000 in 2013—received by a dependent child under age 24 to be taxed at the parents' top tax rate.)

Though transfers to your kids are subject to gift tax, you can use the annual gift-tax exclusion ($14,000 per recipient in 2013) to limit that liability. And the annual exclusion is doubled for joint gifts by a married couple. If there's an excess, it may be covered by the lifetime gift-tax exclusion ($5.25 million in 2013). Similarly, direct gifts to grandchildren are sheltered from the generation-skipping tax by an exemption of the same amount.

Realize, though, that these are irrevocable gifts, so you're giving up complete control over the property. If you're not comfortable with that, you'll need to consider other options for reducing those higher taxes. ●

‘Tis The Season To Receive RMDs

When you’re putting together this year’s holiday shopping list, don’t forget to add one gift that you may need to give to yourself: a required minimum distribution (RMD). If you’ve reached age 70½, you’ll have to take an RMD from your 401(k), traditional IRA, or any other retirement plan that lets you shield your contributions from taxes. And the penalty for missing this obligation is a lot worse than getting a lump of coal in your stocking.

The funds that remain in your employer-sponsored retirement plans and IRAs can continue to grow without current investment or income taxes, but you must begin taking RMDs by April 1 in the year after the year in which you turn 70½. Thereafter, you must make the required withdrawal by December 31 of each and every succeeding year. So if you turned 70½ in 2012, you had to take the RMD for the 2012 tax year by April 1, 2013—and now you must withdraw another RMD for the 2013 tax year by December 31, 2013. You’ll pay federal income tax on these distributions, plus you may owe state income tax, too.

There’s an exception for employer-sponsored plans that may apply if you’re still working full-time and you don’t own 5% or more of the company. In that case, you can postpone withdrawals until your retirement. But you’ll still have to take RMDs from your IRAs.

How much do you have to withdraw? First, look up your life expectancy in the special IRS tables. If your spouse is the sole beneficiary for an account, his or her age also may enter into the equation. Distributions are based on the value of all of your accounts on the last day of the previous tax year. For example, suppose you’re age 75 and the value of all of your IRAs on December 31 of last year was $500,000. If your spouse is the sole beneficiary and is less than 10 years younger than you are, the withdrawal factor under the appropriate table is 22.9 Using an online calculator, you can determine that the RMD for the 2013 tax year is $21,834.

Though the IRS requires you to take these withdrawals, if you have multiple 401(k)s or IRAs, you have some degree of flexibility. For instance, you can take the entire required IRA amount from one IRA or divide up the RMD among all your IRAs. The same principle applies to RMDs from 401(k)s.

What happens if you fail to take an RMD? The IRS can impose a harsh penalty equal to 50% of the amount that should have been withdrawn (or the difference between the required amount and any lesser amount that was distributed). For instance, if you failed to take the RMD in the example above, the penalty would be $10,917. That penalty is in addition to the regular income tax you owe on the RMD.

To be on the safe side, arrange to receive your RMD well before the December 31 deadline. You don’t want to be hit with a hefty penalty if there are any glitches. ●

Capital Gains Reap Rewards

(Continued from page 1)

that exceeds $200,000 for single filers and $250,000 for joint filers. Thus, your effective tax rate on some income could be as high as 43.4%.

These new rules could result in situations in which it would be important to reap tax benefits from capital gains. Consider the following:

- If you already have realized capital losses this year, any capital gains you take between now and the end of the year will be effectively tax-free up to the amount of your net loss—and thus could help you avoid paying the higher rates on long-term gains.
- If you happen to qualify for the 0% long-term capital gain rate for 2013, be sure to take advantage of this unique tax shelter. The upper income limit for avoiding tax on long-term gains is $36,250 for single filers and $72,500 for joint filers. That might apply if, for example, you’re an S corporation owner and your firm is operating at a loss this year. In that case, you might forego the traditional strategy of harvesting tax losses at year-end and hold those losses until 2014.
- If you qualify for the maximum 15% tax rate on long-term capital gains, you still might as well cash in your gains this year, especially if you think you might have to pay the higher 20% rate next year. It’s not often you would volunteer to pay taxes sooner rather than later, but this may be one of those times.
- Even if you must pay the 20% maximum tax rate on long-term capital gains this year, your situation still might call for harvesting some gains. There’s also a chance that future rates could be higher.
- But if you carried over a short-term capital loss from 2012, try not to realize long-term capital gains in 2013. Though the loss could offset those long-term gains, using it in that way would waste the benefit of the preferential tax treatment that long-term gains receive. You might postpone taking long-term gains until 2014, or you could realize a short-term capital gain in 2013 instead. Keep in mind that the gap between tax rates for short- and long-term gains for investors in the top regular income tax bracket is very wide—19.6 percentage points (39.6% - 20%).●