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VOLUME 23 | EDITION 01

Sterling Investment Advisors Ltd.
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"What advice do I need to get ready for the taxman?"

By Timothy E. Flatley

When you file your 2013 income tax return, be prepared to pay more taxes. The American Taxpayer Relief Act of 2012 includes a number of significant changes to earned and unearned income. Yet the act's title may give pause: Inclusion of the term "relief" in any governmental legislation reminds me of a quote from Ronald Reagan: "The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help.'"

To those who find themselves adversely affected by many of the new tax-increase provisions, the Taxpayer Relief Act is anything but relief.

Phil Mickelson's 2013 Scottish Open and British Open victories provide a great example of how taxes can drain income. After Mickelson won the events in back-to-back weeks, he was taxed roughly 44 percent by the United Kingdom, but did not have to pay U.S. federal income tax because of a treaty between the nations. He will still owe the 2.9 percent Medicare tax and the new Medicare surcharge tax of 0.9 percent, however. Furthermore, California, Mickelson's home state, will assess a 13.3 percent state income tax, resulting in an effective total rate of near 61 percent.

While most of us will not incur a tax situation of this complexity and magnitude, we can still be saddled with a hefty tax liability. Beginning in tax year 2013 (generally for tax returns filed in 2014), a new tax bracket of 39.6 percent has been added for individuals whose income exceeds $400,000 ($450,000 for married taxpayers filing a joint return). The other marginal rates—10, 15, 25, 28, 33 and 35 percent—remain the same as in prior years.

Tax rates for unearned income have also jumped. For the highest-income earners, dividend and capital gain tax rates have increased from 15 percent to 20 percent, and a 3.8 percent Obamacare surtax on net investment income can bring the total all the way to 23.8 percent. Add state income taxes to the mix, and many taxpayers could be looking at effective rates in the 40 percent to 50 percent range.

While these tax increases are known, new phase-outs on itemized deductions and personal exemptions are not: The 2013 standard deduction (tax year 2012) rises to $6,100 ($12,200 for married couples filing jointly), up from $5,950 ($11,900 for married couples). The new act also limits itemized deductions for individuals with incomes of $250,000 or more ($300,000 for married couples filing jointly).

Overall, the American Taxpayer Relief Act of 2012 represents the largest tax increase in over two decades. As the low tax rates we have enjoyed disappear, proper tax planning and investment management is more vital than ever. Be proactive, to relieve some of the pressure this act has exerted on taxpayer finances.

TACTICS FOR REDUCING TAX LIABILITY

With the onslaught of higher taxes, there are a number of tactics that can reduce your tax liability:

- Deferring the maximum allowable amount to your 401(k) plan is a good start. Some executives also have access to deferred compensation plans that allow them to push receipt of compensation to future years.

- Funding health-care spending accounts allows taxpayers to use pretax income for deductibles and copays. Some business owners are implementing defined benefit pension and other retirement plans that allow for larger contributions.

- The new tax scenario increases the motivation to hold investments as long as possible, as taxes on gains made do not kick in until a sale occurs. Dividends are taxed at a lower rate, if they are "qualified." The maximum tax rate for a qualified dividend is 20 percent, if the stock is held for 60 days during the 121-day period that begins 60 days before the ex-dividend date.

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