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Year-End Investment Planning and the Fiscal Cliffhanger

Investment planning at the end of 2012 revisits issues that have complicated the planning process for the last two years--tax cut extensions and spending cuts designed to reduce the U.S. budget deficit. Uncertainty about both and whether they will lead to what's been called a "fiscal cliff" in 2013 is likely to affect year-end investment planning yet again.

Despite the uncertainties--or perhaps because of them--it might be worth starting early to look at various "what-if" scenarios in case you need to make last-minute changes to your portfolio. Even though you may not be sure of exactly what will happen in 2013, here are some factors to keep in mind as you plot your year-end strategy.

Review timing of your investment sales

As of January 1, tax brackets are scheduled to return to their pre-2001 levels. That means the current six tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) are scheduled to become five (15%, 28%, 31%, 36%, and 39.6%). Also, absent further changes, the maximum tax rate on long-term capital gains, currently at 15%, will increase to 20% (10% for those in the 15% tax bracket); those in the 10% or 15% marginal income tax bracket, who now pay a 0% rate on capital gains, will lose that special rate. Finally, qualified dividends, now taxed at a maximum of 15%, will once again be taxed at ordinary income tax rates.

Another factor for high-income individuals in 2013 is a new 3.8% Medicare contribution tax on some or all of the net investment income of individuals with a modified adjusted gross income over $200,000 ($250,000 for married couples filing jointly, and $125,000 for couples filing separately).

Ordinarily, higher rates in 2013 might suggest taking profits in an investment before those higher rates go into effect. However, the November election could affect the scheduled expiration date of those tax cuts, or even whether they expire at all. As a result, it's especially important this year not to let tax considerations be the sole factor in any investment decision. If you're uncertain about a sale, remember that another way to minimize capital gains taxes is to harvest investment losses that may offset gains.

Consider the potential economic impact of 2013

The nonpartisan Congressional Budget Office has warned that the tax increases and the roughly $109 billion in spending cuts could hamper an already sluggish economic recovery. Also, a 2% reduction in the Social Security portion of the payroll tax is scheduled to expire in January, leaving consumers with less to spend. Though there has already been talk about revisiting the spending cuts and tax cut expirations, you might want to consider how your portfolio might be affected.

Some companies are highly sensitive to economic cycles; others offer products and services that people need regardless of how the economy is doing and generally suffer less from a downturn (though any industry or company can have its own challenges). Also, the spending cuts could disproportionately affect some specific industries, such as defense, and companies that rely heavily on government contracts.

Interest rates and European instability

Partly because of the Federal Reserve's monetary policy and partly because of the European debt situation, interest rates have been at historic lows in recent months. This has meant higher prices for U.S. Treasury bonds, because bond yields move in the opposite direction from bond prices. However, investors who have relied on Treasuries for income and now want to roll over the proceeds of maturing bonds might be disappointed with available rates, which the Federal Reserve expects to remain low well into 2014. If that's the case for you, you may need to explore supplemental sources of investment income, or reexamine your Treasury holdings to see whether they now represent too much of your portfolio.

Even if you decide to wait and see what happens at year-end, planning for multiple scenarios now could help improve any last-minute decisions.

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