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First-Quarter 2012 Market Review ~ Taxes, Taxes, Texas

April 2012 - What does Texas have to do with taxes? Read below about the "Taxmageddon" coming in 2013.

It was the best first quarter for stocks since 1998 as the rally begun last October carried into the new year. Domestic stocks posted low to mid-double-digit advances for the second consecutive quarter, while international indexes joined the multi-digit pack.

Although the Federal Reserve left short-term interest rates unchanged during the quarter, long-term rates rose, mitigating returns for broad-market bond indexes. The yield on the 10-year Treasury note jumped to as high as 2.40% during the quarter and closed at 2.21%, up 33 basis points from year end (the yield as of April 17th was 2.00%). The riskiest bond sectors performed well, with International Emerging Markets expanding 5.5% and U.S. High Yield gaining 5.3%.

In January, citing expectations for high levels of unemployment for the next three years, the Fed announced that it expects to keep short-term interest rates near zero through 2014. This was an extension from the previous outlook through mid-2013. The Fed also released projections for future interest rate increases from 17 senior officials on its Federal Open Market Committee (FOMC): 11 forecast interest rates to climb in 2014 or later, while the remaining six predict they will rise in 2012 or 2013.

After its March meeting, the Fed said the economy is expanding moderately, with consumer and business spending up. However, global financial strains are a potential threat and the U.S. housing market remains depressed. With the $25 billion settlement between states and banks regarding "improper" foreclosure practices, the foreclosure pipeline will be unleashed, potentially depressing prices further in some markets.

Below are rates of return for selected market indices for the first quarter of 2012, full-year 2011, and the three, five, and 10-year compound annual returns as of December 31, 2011.

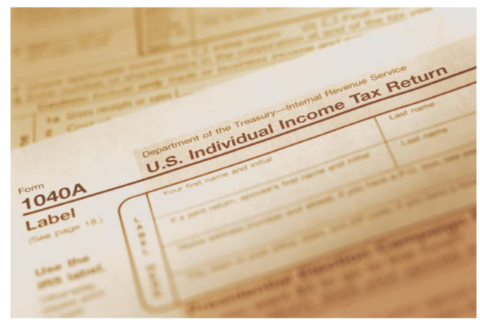
	1Q:2012	2011	3-Year	5-Year	10-Year
Equity (Stock) Indices					
Domestic Large Cap					
Russell 1000 - Growth	14.69%	2.64%	18.02%	2.50%	2.60%
Russell 1000 - Value	11.12%	0.39%	11.55%	-2.64%	3.89%
Russell 1000 - Blend	12.90%	1.50%	14.81%	-0.02%	3.34%
Domestic Small Cap					
Russell 2000 - Growth	13.28%	-2.91%	19.00%	2.09%	4.48%
Russell 2000 - Value	11.59%	-5.50%	12.36%	-1.87%	6.40%
Russell 2000 - Blend	12.44%	-4.18%	15.63%	0.15%	5.62%
Real Estate (FTSE EPRA/NAREIT Global)	13.46%	-8.14%	15.91%	-5.37%	NA
Dow Jones - UBS Commodity	0.87%	-13.37%	6.26%	-3.32%	4.69%
International					
MSCI EAFE Developed Large Cap	10.98%	-11.73%	8.16%	-4.26%	5.12%
MSCI EAFE Developed Small Cap	14.94%	-15.66%	15.00%	-3.80%	9.42%
MSCI Emerging Markets	14.14%	-18.17%	20.42%	2.71%	14.20%

Fixed-Income (Bond) Indices

Barclays Capital					
Global Aggregate	0.87%	5.64%	6.13%	6.52%	7.18%
U.S. Aggregate	0.30%	7.84%	6.77%	6.50%	5.78%
U.S. Treasury TIPs	0.86%	13.56%	10.38%	7.95%	7.57%
U.S. Corporate High Yield	5.34%	4.98%	24.12%	7.54%	8.85%
Municipal	1.75%	10.70%	8.57%	5.22%	5.38%
International Emerging Markets	5.51%	6.97%	17.45%	7.76%	11.08%

Source: russell.com, reit.com, djindexes.com, msci.com, barcap.com

Taxes, Taxes, Texas



What does Texas have to do with taxes? George W. Bush is from Texas and taxes were lowered twice during his presidency ("the Bush tax cuts"). In addition, taxes and Texas are anagrams. Otherwise, not much in this case, but I want to make sure I have your attention about the "Taxmageddon" coming in 2013. Before you file away your 2011 tax return documents, now is the time to focus on tax strategies for 2012 and beyond.

The Bush tax cuts were scheduled to end at the close of 2010, but were extended through 2012 in an effort to stimulate consumer spending and the economy. If the tax cuts expire, next year ordinary income (wages, interest income, etc.) rates will go up for all income levels, with the top rate rising from 35% to 39.6%. The charge for long-term capital gains would climb from 15% to 20%, while the 15% rate on qualified dividends would be eliminated, so that qualified dividends would be taxed as ordinary income, with a top rate of 39.6%.

Taxpayers in the highest income tax brackets would see personal exemptions and itemized deductions phased out in 2013, which effectively increases the overall tax rate.

The estate tax exemption of $5.12 million would shrink to $1 million in 2013, while the top tax rate for excess amounts would increase from 35% to 55%. The gift tax exemption would also revert to $1 million from $5.12 million, with an equal change in tax rate.

Also looming for 2013 are "high-income" taxes associated with the 2010 Health Care Act, including an additional Medicare payroll tax of 0.9% and a new Medicare surtax on net investment income of 3.8%. The payroll tax and surtax will both have thresholds of $200,000 for individuals and $250,000 for married couples filing jointly. The thresholds are not scheduled to be indexed for inflation.

The payroll tax will be levied on earnings of self-employed individuals or wages of an employee in excess of $200,000 ($250,000 if filing jointly). Self-employed individuals will not be permitted to deduct any portion of the additional tax. The additional 0.9% raises the amount paid by employees to 2.35% from 1.45%. Employers will continue to pay 1.45%, while self-employed taxpayers subject to the added tax will pay a total of 3.8%.

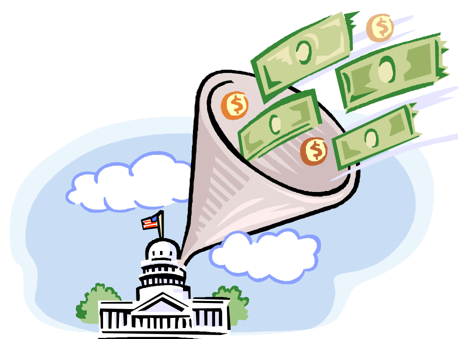
The new surtax would apply to "unearned income" such as interest, capital gains, annuities, rents, royalties, and dividends. The 3.8% surtax will be levied on the lesser of: (1) net investment income or (2) modified adjusted gross income (AGI) in excess of the $200,000/$250,000 thresholds. The surtax would essentially increase the top rate for ordinary income and qualified dividends to 43.4%, with long-term capital gains taxed at 23.8%.

As if the tax code is not complicated enough…

Taxpayers at all income levels could be affected by other changes stemming from the health care legislation through new limits on medical flexible spending accounts (FSAs) and itemized medical deductions. Beginning in 2013, the limit on pre-tax contributions to a FSA will be reduced to $2,500, but will thereafter be indexed to inflation. (Although current law imposes no limits, most employers restrict annual contributions at $5,000 or higher.) Medical expenses will only be deductible if they exceed 10.0% of AGI, up from 7.5% (a taxpayer 65 and older, or whose spouse is 65 or older, will still have the 7.5% threshold through 2016).

Finally, the payroll tax holiday, which reduces the employee portion of Social Security tax by 2.0% (from 6.2% to 4.2%), stops at the end of 2012. The 2.0% reduction also applies to self-employment taxes (from 12.4% to 10.4%).

With tax reform unlikely prior to the November election, tax planning is more complex and uncertain. Adding to the current cloud of uncertainty is not knowing what will happen to the taxes included in the 2010 health care reform if the Supreme Court overturns part of the legislation. What is known is that doing nothing prior to 2013 will trigger one of the biggest tax increases in U.S. history, estimated to be nearly $5 trillion over the next decade. Pundits expect some action during the lame-duck session after the election.



Some strategies to mitigate the upcoming tax minefields:

- High-wage earners may want to accelerate income and avoid deferring compensation.
- Consider deferring charitable contributions to benefit from higher future tax rates.
- Investors should employ tax-loss harvesting portfolio strategies to accumulate losses for future use to offset gains that would be taxed at a higher rate.
- Investors may want to accelerate the sale of assets with large long-term capital gains in 2012 to benefit from the lower 15% rate. If these gains are realized, realizing losses should be deferred until a future year when they can offset gains that may be taxed at a higher rate.
- Consider bunching medical expenses in 2012 if they will exceed 7.5% of AGI.
- Convert Traditional IRAs to a Roth IRA. Retirement account distributions are exempt from the new Medicare surtax, but certain amounts may count in the calculation of AGI and help push modified AGI over the surtax income thresholds. Under current law, distributions from a Roth are not counted in the calculation of AGI and would thus avoid the Medicare surtax.

As the country-western song says, "All your 'exes' may be in Texas," but taxes will take their toll wherever you live. The impending changes make tax-efficient locating of investment assets more crucial than ever.

Please contact Kalorama Wealth Strategies if you would like to discuss how we might help you minimize your tax exposure. For more information on our investment advisory and financial planning services, please see our web site at www.kaloramawealth.com.

Thank you for your continued business and referrals. Please feel free to forward this newsletter to friends and colleagues who can benefit from information about investing and financial planning. If I can be of any assistance to you or anyone you know, please do not hesitate to contact me.

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