KANAWHA
CAPITAL MANAGEMENT

First Quarter 2014

This Quarter's Highlights

- New Long-Term Capital Gains and Qualified Dividends Tax Rate
- New Medicare Surtax on Net Investment Income
- A Combined Rate Approach to Tax Planning
- 2014 Important Financial Data

Kanawha Currents

April Madness: Pick the winning bracket

Many investors will begin to see the impact of higher tax rates enacted from the *American Taxpayer Relief Act* and the *Affordable Care Act* as they complete their 2013 tax returns. Beginning last year, the top long-term capital gains rate increased from 15% to 20% for taxpayers with income in the new 39.6% bracket. The same holds true for qualified dividends, which includes income from most stocks and stock mutual funds. Additionally, a new Medicare surtax of 3.8% will be levied on net investment income that falls above certain thresholds. This means long-term capital gains rates for certain high-income investors could be as high 23.8%, almost 9 percentage points higher than in 2012. But not all investors will be subject to these higher taxes. The 0% and 15% rates on long-term capital gains and qualified dividends remain in place for the majority of taxpayers.

The new *taxes*, *rates*, and *thresholds* have added to the complexity of tax planning for investors and their advisors. While it is generally prudent not to let the proverbial "tax tail wag the investment dog," the current landscape may challenge this mantra. The wider range of potential outcomes with respect to tax liability is likely to place a higher premium on tax planning for investors. Individual investors should consider their circumstances carefully to understand which strategy benefits them the most in a given year. The traditional approach of *deferring* gains to future years may still be the preferred strategy for many, but current rules may create situations where investors are better served *accelerating* gains. We will attempt to clarify these new rules and discuss various factors investors might consider under current tax law.

Investors are now subject to a 0%, 15%, or 20% rate on realized long-term capital gains (on securities held for greater than one year) and qualified dividends. These rates are determined by which "bracket" the investment income falls into. Our tax code fills up your bottom brackets with ordinary income first, adjusted for deductions and exemptions, and then adds long-term capital gains on top. Whatever marginal bracket(s) your long-term capital gain income falls into determines which capital gains tax will be applied (see Figure 1). Note that gains realized on assets held for one year or less will be subject to ordinary income tax rates and will not receive preferential tax treatment.

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Figure 1: Tax Rates on Long-Term Capital Gains and Qualified Dividends

If taxpayer's long-term gain income falls into this bracket, then tax rate is …	Rate
10% or 15%	**0%**
25%, 28%, 33%, or 35%	**15%**
39.6%	**20%**

Source: IRS.gov

The new Medicare surtax of 3.8% on net investment income must also be factored in. Investors are more likely to be subject to this tax because the income thresholds are much lower than those associated with the higher capital gains rate. They are $250,000/$200,000 for joint/single filers compared to $450,000/$400,000 for the new capital gains rate. Furthermore, the Medicare tax is based on *Modified Adjusted Gross Income* (income before many deductions and personal exemptions are applied), whereas the new capital gains threshold is a function of *taxable income* (after deductions and exemptions are used to lower income subject to taxes).

These rules certainly have the potential to make investment tax planning more complicated. However, *combining* the new surtax with the capital gains tax actually produces four broad rate categories that almost all amounts of long-term gains and qualified dividends will fall into. Instead of looking at the capital gains rates and the Medicare surtax rates separately, the more practical way to determine one's tax rate on a given dollar of long-term capital gain income is through one of these four combined rates: 0%, 15%, 18.8%, and 23.8%. With very few exceptions, each dollar of long-term gains and qualified dividends will be taxed at one of these rates (see Figure 2).

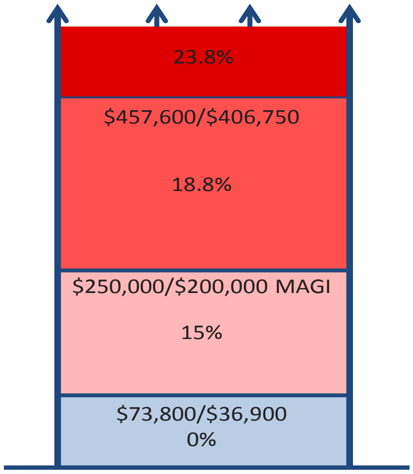
Figure 2: Four Combined Rates on Long-Term Capital Gains and Qualified Dividends

LT Capital Gains Rate	Married Filing Jointly Income	Single Filer Income
0%	Taxable Income < $73,800	Taxable Income < $36,900
15%	Taxable Income > $73,800, but MAGI < $250,000	Taxable Income > $36,900, but MAGI < $200,000
18.8%	MAGI > $250,000, but Taxable Income < $457,600	MAGI > $200,000, but Taxable Income < $406,750
23.8%	Taxable Income > $457,600	Taxable Income > $406,750

Source: IRS.gov, Michael Kitces *Nerd's Eye View*. Income ranges based on 2014 figures.

Which one of these rates an investor pays will depend on their filing status (Single, Married Filing Jointly, etc.) and which income range(s) their investment income falls into. A portion of the income may fall into one range and be taxed at one rate and a portion may fall into a higher range and be taxed at a higher rate. This is because the same graduated rate structure that is used to tax ordinary income is also applied to long-term capital gain and dividend income. Each dollar of capital gain income is taxed at the marginal rate (0%, 15%, 18.8%, 23.8%). In other words, the marginal rate is not retroactive back to the first dollar of capital gain income.

Figure 3: Four Combined Rates on Long-Term Capital Gains and Qualified Dividends that Fall into Given Ranges (MFJ and Single thresholds only)



Below are three scenarios that illustrate various strategies investors may employ to minimize their taxes and maximize their gains.

Example 1: A retired married couple has ordinary income of $80,000. After deductions and exemptions, their taxable income is approximately $63,000. Let's assume it's December, 2014, and they are considering selling a stock position with an unrealized long-term gain of $20,000. Normally, they would be inclined to defer the gain to the next tax year, but after discussing the situation with their tax accountant, they are advised to sell half of the shares this year and the other half in 2015. This way, assuming their other income stays the same in 2015, they will likely pay zero taxes on the entire gain. This is because they have the capacity to harvest gains before the 15% capital gains tax threshold is breached. Even though they will still be able to sell the total position within a short period of time, they smartly "use up" the 0% rate in each of the two years and avoid taxes altogether, saving them approximately $1,380 in taxes.

Example 2: A Single filer has $125,000 in Social Security, pension, and dividend income in 2014. She has a large IRA valued at $2,000,000 and is due to take her first Required Minimum Distribution (RMD) of approximately $75,000 in 2015. She also has a taxable investment account and is considering liquidating a concentrated stock position with an unrealized gain of $50,000. After estimating that her total income in 2015 will increase to about $200,000, she determines it is best to realize all of the $50,000 gain in 2014. By accelerating the $50,000 gain this year, she will ensure that she pays the 15% rate versus a projected rate of 18.8% next year. Because her income will be higher from the RMD in 2015, all of the capital gain would fall over the Medicare surtax threshold. *There will likely be some offset to the tax savings in future years due to higher Medicare B premiums from the increase in 2014 income*.

Example 3: A married couple has projected taxable income of $450,000 in 2014 and wants to sell a holding with unrealized long-term gains of $30,000. They are retiring in January of 2015 and their Adjusted Gross Income is projected to decline to about $200,000 next year. In this example, the couple should strongly consider deferring the $30,000 gain to 2015. Their likely tax rate on this gain would decline from 23.8% to 15%, saving them about $2,640 in federal taxes.

Investors should know how much of the current market value of a taxable capital asset is theirs and how much belongs to Uncle Sam. Rather than trying to analyze potential effects from the new capital gains and Medicare taxes independently, investors should consider which of the four broad rate categories that each marginal dollar of long-term capital gain and qualified dividend will fall into. Awareness of the new tax rules *and* understanding how to apply them to their current portfolio may allow taxpayers to reduce any embedded tax liabilities without compromising their investment objectives. While the deferral of realized gains to future years may still be an appropriate tactic, investors and their advisors should examine the situation carefully to consider whether accelerating gains might be more beneficial. Of course, working with your tax professional to evaluate these issues and other considerations such as the Alternative Minimum Tax, lost credits, and possible phase-out of certain deductions and exemptions is advised.

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2014 Important Financial Data

2014 Tax Rate Schedule	
Taxable Income	Marginal Rate
Single	
$0 to $9,075	10%
$9,076 to $36,900	15%
$36,901 to $89,350	25%
$89,351 to $186,350	28%
$186,351 to $405,100	33%
$405,101 to $406,750	35%
$406,751 +	39.6%
Married Filing Jointly & Surviving Spouse	
$0 to $18,150	10%
$18,151 to $73,800	15%
$73,801 to $148,850	25%
$148,851 to $226,850	28%
$226,851 to $405,100	33%
$405,101 to $457,600	35%
$457,601 +	39.6%
Head of Household	
$0 to $12,950	10%
$12,951 to $49,400	15%
$49,401 to $127,550	25%
$127,551 to $206,600	28%
$206,601 to $405,100	33%
$405,101 + $432,200	35%
$432,201 +	39.6%
Married Filing Separately	
$0 to $9,075	10%
$9,076 to $36,900	15%
$36,901 to $74,425	25%
$74,426 to $113,425	28%
$113,426 to $202,550	33%
$202,551 to $228,800	35%
$228,801 +	39.6%
Estates and Trusts	
$0 to $2,500	15%
$2,501 to $5,800	25%
$5,801 to $8,900	28%
$8,901 to $12,150	33%
$12,151 +	39.6%

Capital Gains Tax Rates	
Short-term (held 1 year or less)	Same as ordinary income
Long-term (held > 1 year):	
If income falls in 10% or 15% brackets	0%
If income falls in 25%,28%,33%, or 35% brackets	15%
If income falls in 39.6% bracket	20%
Unrecaptured gains on Section 1250 property	25%
Collectibles	28%

Qualified Dividend Income Tax Rates	
If income falls in 10% and 15% brackets	0%
If income falls in 25%,28%,33%, and 35% brackets	15%
If income falls in 39.6% bracket	20%

Income Tax Deductions and Exemptions	
Standard Deduction	
Single	$6,200
Married filing jointly	$12,400
Head of household	$9,100
Over age 65 or blind additional standard deduction	
Married or surviving spouse	$1,200
Single or not a surviving spouse	$1,550
Itemized deduction may be reduced by 3% of every dollar that exceeds certain AGI thresholds	
Personal exemption	$3,950
Personal exemption may be reduced by 2% for every $2,500 that exceeds certain AGI thresholds	

Retirement Plan Contribution Limits	
401(k), 403(b), 457 plans elective deferrals	$17,500
Catch-up contributions for 50 and older	$5,500
Defined contribution plans	$52,000
Defined benefit plans	$210,000
SIMPLE plans elective deferrals	$12,000
Catch-up contributions for 50 and older	$2,500
Traditional and Roth IRA	$5,500
Catch-up contributions for 50 and older	$1,000
Traditional IRA deductibility for active participants	Phaseout Limits:
Single	$60,000 to $70,000
Joint	$96,000 to $116,000
Spousal IRA if one spouse is covered by a plan	$181,000 to $191,000
Married filing separately	$0 to $10,000
Roth IRA income phaseout	
Single	$114,000 to $129,000
Joint	$181,000 to $191,000
Married filing separately	$0 to $10,000

Estate and Gift Tax	
Annual gift tax exclusion	$14,000
Estate and gift tax exclusion	$5,340,000
Maximum estate tax rate	40%

New Medicare Surtaxes
0.9% on wages that exceed $200,000 (single filers) or $250,000 (joint filers)
3.8% on net investment income that falls above MAGI of $200,000 (single filers) or $250,000 (joint filers)

Medicare			
Part A Hospitalization			
First 60 days inpatient deductible		$1,216	
Days 61 - 90		$304 per day	
Days 91 +		$608 per day, up to 60 days over lifetime, then full amount per day	
Part B Premium			
MAGI Single (for *2012*)	MAGI Joint (for *2012*)	Part B Monthly Premium	Part D Increase
$85,000 or less	$170,000 or less	$104.90	$0
$85,001 to $107,000	$170,001 to $214,000	$146.90	$12.10
$107,001 to $160,000	$214,001 to $320,000	$209.80	$31.10
$160,001 to $214,000	$320,001 to $428,000	$272.70	$50.20
$214,001 +	$428,001 +	$335.70	$69.30
Part B Deductible	$147		
Coinsurance	20% of Medicare-approved amount for most services		

Long Term Care Insurance: Potential Deductibility of Premiums for Qualified Policies (medical expenses are subject to % of AGI thresholds)	
Age	Amount of premium that may be treated as "medical care"
40 or less	$370
41 to 50	$700
51 to 60	$1,400
61 to 70	$3,720
71 +	$4,660

Source: www.irs.gov, IRS Rev. Proc. 2013-35, IR-2013-86, IR-2013-87, Centers for Medicare & Medicaid Services
The data contained on this sheet is for informational purposes only and should not be interpreted as tax or investment advice.
Consult your tax professional for specific advice about your personal situation.