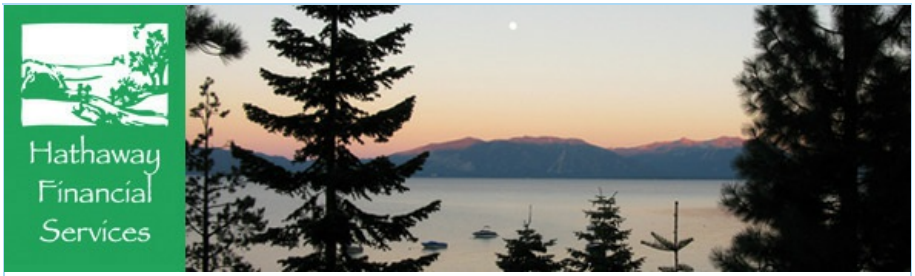

Tax Season 2012, Really?

Tax season 2011 is now officially over. While it may feel good to have your taxes behind you, it is not too early to start thinking about your tax bill for 2012. There are several significant tax opportunities that are currently scheduled to expire at the end of 2012. Of course, being an election year, don't expect any action from Congress until after the elections in November, if at all. Although we can't predict with certainty what the tax situation will be on Jan 1, 2013, don't let that limit your planning opportunities available to you now.

Capital Gains

Capital gains taxes are taxes you pay on gains when you sell an investment asset in a taxable account (capital gains do not apply in tax-deferred retirement accounts such as 401(k)s and IRAs). Capital gains are long-term if they have been held for more than one year, short-term if held for one year or less. The gain is the amount at sale minus all purchase amounts, also referred to as cost basis. Currently, the tax rates for long-term capital gains are historically low. For taxpayers in the 15% (or lower) federal income tax bracket, the long-term capital gains rate may be as low as 0%. For taxpayers in the 25% (or higher) federal income tax brackets the current long-term capital gains rate is 15%. After 2012, these rates are scheduled to sunset back to 10% and 20% respectively, unless Congress intervenes. (Note that Oregon taxes capital gains as if they were ordinary income, so there is no break on your state income taxes.)

Lets take an example: Mary bought 10 shares of XYZ Corp on June 1, 2010 for $243 per share, for a total cost of $2,430. She held her XYZ shares until March 1, 2012, when she sold her 10 shares for $600 per share, for a total value of $6,000. Her gain of $3,570 ($6,000 - $2,430) would be subject to long-term capital gains rates, since the stock was held for longer than one year. If Mary's taxable income falls in the 15% federal tax bracket, she would pay $0 on this gain. If, however, her income is taxed in a higher tax bracket, she would pay $535. Take the same gain, but assume this time that Mary waited until 2013 to sell her stock. Assume also that Congress let the tax cuts sunset, and the long-term capital gains tax rate is now 10% for those in the 15% and lower tax brackets, and 20% for those in the higher tax brackets. Mary's tax would now be $357 if it was taxed in the 15% tax bracket (as opposed to $0), and $714 (vs. $535) if it was taxed in the higher tax brackets.

This example demonstrates the potential tax savings that may be available by accelerating the sale of securities with gains into tax year 2012. Under current tax laws, there is an added benefit to this strategy. If Mary doesn't want to give up her XYZ stock, she can sell the security, realizing the gain for tax purposes, then buy the stock back at the same price, setting a new higher cost basis, a process called "gain harvesting".

Roth IRA Contributions

For eligible taxpayers, Roth IRA contributions are an excellent way to shield income from future tax rates. Contributions to Roth IRAs are made with post-tax monies, so contributions made in 2012 are made with monies taxed at 2012 rates. However, qualified distributions taken in future years may be non-taxable. That XYZ stock Mary sold in her taxable account could be re-purchased in her Roth IRA. When she sells it years in the future, all gains may be tax-free income to her. Depending on your individual situation, this may be an excellent environment for realizing taxable gains in investments in your taxable accounts, and re-purchasing them in a Roth IRA account, where future gains will be shielded from taxation.

While there are many other tax provisions currently scheduled to expire at the end of 2012, these strategies may enable you to attain significant tax savings now, and years into the future, regardless of 2013 tax rates. Examining your investments and taking action now, will enhance your ability to take advantage of these opportunities as they arise. Planning early really does help to maximize the benefit.

We recommend consulting with your tax advisor in advance, regarding the consequences of any investment strategy, and will be happy to work with your advisor in this respect.