



The American Taxpayer Relief Act of 2012: What Got Saved and What It Means for You

Following weeks of tense negotiations and technically falling off the fiscal cliff for one day, the U.S. Congress finally reached an agreement averting the full force of tax increases that were scheduled to take effect on January 1, 2013. While spending cuts and other important fiscal issues were not truly addressed but merely postponed, the passage of The American Taxpayer Relief Act (ATRA) of 2012 did resolve some lingering uncertainties and provide some good news for investors—especially as it applies to preferential tax treatment for qualified equity dividends and municipal bond income. Indeed, for many, both dividend-paying equities and municipal bonds may be more attractive investments than ever given higher tax rates for some and given the low interest rate environment that persists, making it hard to find income elsewhere.

Here are just a couple of highlights of the fiscal cliff deal and, in turn, strategies that investors might want to consider.

Tax Rates on Capital Gains and Dividends Were Maintained for Most.

The fiscal cliff deal dubbed ATRA left unchanged and permanently extended the 0% and 15% tax rates for long-term capital gains and qualified dividends for single filers with taxable incomes below \$400,000 and for joint filers with taxable incomes below \$450,000. That is, taxpayers in the 25%, 28%, 33% and 35% tax brackets will continue to pay 15%, while those in the 10% and 15% tax brackets will continue to be exempt from taxes on capital gains and

dividends. The top rate for capital gains and dividends will permanently increase to 20% for filers with taxable incomes above these thresholds, i.e. those in the new 39.6% tax bracket. That said, the new 3.8% Medicare tax enacted under the healthcare law takes effect in 2013. The new 3.8% tax applies to single filers with modified adjusted gross income (MAGI) above \$200,000 and joint filers with MAGI above \$250,000. As a result, the tax law will include four different rates for long-term capital gains and qualified dividends depending on the investor's MAGI and taxable income—0%, 15%, 18.8% and 23.8%.

Tax-Exempt Status of Municipal Bond Income Remained Unchanged.

The municipal bond tax-exemption survived the first round of fiscal cliff negotiations. Also, notably, municipal bond interest will not be eliminated as an exemption for higher income earners even with the personal exemption phase-out and itemized deduction limitations that are now in place as part of ATRA.

So, what lessons should investors take away from the deal as you move ahead with your investment strategy over the remainder of the year?

Keep a Long-Term Perspective. Now that some clarification has been achieved following the tax deal, investors should review their investment portfolios to make sure current asset allocation balances still match long-term goals and individual time

horizons. While maintaining an emergency fund for unforeseen near-term possibilities is critically important, so, too, is thinking ahead, planning ahead and investing for your future.

Reconsider Stocks. If you are a long-term investor and had taken a more defensive portfolio stance in the last months of 2012, then it may be a good time to reconsider the equity market. We already saw in the first quarter of 2013 that after some clarity was achieved on the tax debate, investors returned to dividend-paying stocks in search of yield and a more conservative strategy for equity investing. Indeed, after seeing outflows of more than \$9.2 billion just in the one week ending January 2, 2013, domestic equity mutual funds saw inflows exceeding \$19.6 billion in the next four weeks of January 2013.¹ Many analysts believe that riskier assets, including stocks, may perform reasonably well if fiscal policy is addressed in earnest and economic growth rates remain positive. Still and as always, the principle of diversification, not only amongst asset classes but also within the equity market, to styles, capitalizations, regions and sectors, remains important.

Be Tax Efficient. Income tax rates on top earners are going up and even those in the “middle class” may well feel a bigger dip into their pockets from the IRS via limits on exemptions and deductions, the new Medicare surtax and the increase on the payroll tax, the latter of which goes to fund Social Security. That means it is more critical than ever before for investors

to have a tax efficient plan for savings, investment and retirement income. Make the most of your tax-advantaged retirement accounts, including traditional and Roth IRAs, 401(k)s and other retirement savings plans, and review what investments and assets are in those accounts.

And take another look at municipal bonds, which provide federal tax-free income. Municipal bonds may well be the beneficiaries of rising taxes, as their tax exemption becomes increasingly more valued. In 2012, municipal bonds, as measured by the Barclays Municipal Bond Index, returned 6.78%, significantly exceeding the 1.99% return of duration-equivalent U.S. Treasuries, as measured by the Barclays Treasury Index.² Further, at the end of 2012, yields on 10-year AAA general obligation bonds stood at 99% of 10-year U.S. Treasuries³, well above the more historically average level of approximately 80%.⁴ Of course, past performance is no guarantee of future results, and any tax strategy should be implemented in the context of your personal overall financial situation and in consultation with your own tax advisor.

Save More. Volatility in the investment markets will not disappear. Given various provisions of ATRA, many will feel the impact of higher taxes even without a higher income tax rate. Also, changes to Social Security and Medicare may well be part of the next rounds of the fiscal debate, potentially resulting in smaller benefits for those under a certain age. So, not only should you review your retirement savings accounts to make sure you are making the most of their potential advantages, but you might also want to consider finding small ways to cut your own personal expenses. Bring a thermos of coffee with you to work rather than stopping at the corner barista; stock up on non-perishable sale items in

Maximizing Opportunities After the Fiscal Cliff

If you're like many, then you might have been jittery about investing new monies before the fiscal cliff was averted—especially in equities and municipal bonds. But keeping cash on the sidelines is not necessarily a safe strategy either given widespread anticipation for higher inflation following unprecedented quantitative easing policies by the U.S. Federal Reserve (the Fed). Plus, with short-term interest rates anchored near zero until unemployment drops to 6.5% or lower, per the Fed's current stance, the search for yield continues. Dividend-paying equities and municipal bonds—which maintained their

preferential tax treatment in the fiscal cliff deal—may deserve a closer look.

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Adhere to Investment Principles.

Let's face it—ATRA was a patch, not a cure to the economy's persistent fiscal troubles. Debate within Washington D.C. will continue. More changes will come. What investors can do is review one's own investment portfolio, consider your strategy in light of current tax law, consult with your financial and tax advisors and stick with the basics of patience, perspective and portfolio diversification as you seek to achieve your long-term investment goals. What we as investment manager of the Value Line Funds intend to do is adhere to our philosophy based on solid fundamentals, sound investment principles and the power of disciplined and rigorous analytics, including the time-honored, proprietary ranking systems for which Value Line is so highly regarded.

¹ Investment Company Institute, February 6, 2013.

² Barclays, December 31, 2012.

³ Wellington Management, Fixed Income Outlook, First Quarter 2013.

⁴ Deutsche Asset Management, April 2012.

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