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Potentially huge changes ahead for dividends and capital gains rates

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Although the dog days of summer are here, many investors are already thinking about January 1st of next year. Why? Because if Washington does not take any action prior to that date, then the tax on capital gains, currently at 15%, could jump to 23.8% and the tax on dividends, currently at 15%, could jump to as high as 43.4%. That possibility has many investors considering whether they should take preemptive measures during the remainder of 2011.

This enormous jump in capital gain and dividend rates would result from the combined effect of the so-called "Bush-era tax cuts" lapsing and the enactment of the Medicare contribution and payroll tax. If Washington does not take any action, then the Bush-era tax cuts will lapse resulting in a capital gain rate jump from 15% to 20% and a dividend rate jump from 15% to a possible high of 39.6%.

The new healthcare law adds an additional 3.8% tax on both dividends and capital gains for certain taxpayers. The 3.8% tax is imposed on net investment income, which includes capital gains, dividends, annuities, rents, royalties and interest (except tax-exempt interest). The tax applies to single taxpayers with a modified adjusted gross income of $200,000 or more and joint filers with a modified adjusted gross income of $250,000 or more. The taxpayer is responsible for paying the tax.

In addition, the new healthcare law increases the employee portion of the hospital insurance payroll tax by 0.9% for individuals with wages in excess of $200,000 and for joint filers with wages in excess of $250,000. This increase is only applicable to the employee's portion of hospital insurance, not the employer's portion of hospital insurance. An employee could get caught by surprise on this additional hospital insurance tax because the employer is only required to withhold the additional tax for employees who make more than $200,000. Consequently, if the employee and his or her spouse make more than $250,000, but neither spouse makes more than $200,000, then neither spouse's employer will have withheld any amount of this additional tax and the couple will need to pay the additional tax directly. Ultimately it is the taxpayer's responsibility to make sure the tax is paid.

As year-end approaches, it would be a wise idea to contact your investment advisers to glean any guidance they may have for addressing the potential changes that 2013 may bring.

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