PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Special Edition | **October 2012**

Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Sonny C. Lin, CFA, CIC
Senior Portfolio Manager

Alan K. Chuang, CFA, CPA, CFP®, CIC
Portfolio Manager & Business Development Officer

Lily L. Ku, CFP®
Financial Planner

Joseph Fontamillas
Client Service Manager

Grace Hill
Operations Manager

Carmen Pon
Operations Manager

Jennifer S. Ying, CPA
Financial Consultant

Offices:

Southern California:
2540 Huntington Dr.
Suite 105
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
333 Gellert Blvd.
Suite 121
Daly City, CA 94015
Tel: (650) 758-0130
Fax: (650) 758-0131

www.PILLARPACIFIC.com

~ A Good Steward - Tax Planning for an Uncertain Future ~

By Lily L. Ku, CFP®

While the general focus is on how the "Fiscal Cliff", and the tax increases it brings will affect our economy, we would also like to bring your attention to a more personal level - what the tax increases mean to you, the investor, if Congress does not act by the end of this year.

This chart shows that at every income level, the tax rates are going up and estate tax exemption is going down:

Year	Highest Income Tax	Qualified Dividends	LT Capital Gains	Estate/Gift Tax Rate	Estate Tax Exemption	Medicare Tax & Surtax
2011	35%	15%	15%	35%	$5 million	2.9% wages
2012	35%	15%	15%	35%	$5.12 million	2.9% wages
2013 ??	39.6%	Ordinary Income Tax	20%	55%	$1 million	***3.8% wages AND investment income > $200k/$250k***

One complex aspect of the already passed Affordable Care Act is the treatment of Medicare taxes. As noted in the table, the new law will bring an increase of 0.9% , from 2.9% to 3.8% in Medicare tax rates to higher income filers, whose incomes are over $200k for individuals or $250k for couples. Additionally, for these higher income filers, there is an additional surtax (3.8%) that is applied to investment income beyond just the wage income. Here are two examples to illustrate the effect of the increased Medicare tax and surtax on regular wages and investment income:

John (Single filing)		*Additional Tax*
Total Wages	*$190,000*	*$0*
Dividends & Capital Gains, etc.	*$30,000*	
Modified Adjusted Gross Income $220K		
(Over the threshold for the 3.8% surtax on investment income)		
Lower of Net investment income of $30k OR Excess MAGI over $200k threshold of $20k		
20,000 x 3.8% = $760		*$760*
Total Additional Medicare Taxes		***$760***

Bob & Cathy (Married filing jointly)		*Additional Tax*
Combined Wages	*$350,000*	*$900*
Dividends & Capital Gains, etc.	*$50,000*	
Modified Adjusted Gross Income $400k		
(Over the threshold for the 3.8% surtax on investment income)		
Lower of Net investment income of $50k OR Excess MAGI over $250k threshold of $150k		
50,000 x 3.8% = $1,900		*$1,900*
Total Additional Medicare Taxes		***$2,800***

The calculation of the additional Medicare Surtax (formally called the Unearned Income Medicare Contribution Tax) is to multiply 3.8% times the *lower* of:

- Net investment income for the year; **OR**
- Modified Adjusted Gross income (MAGI) over the appropriate threshold amount (i.e., $250k for married filing joint, $200k for single and head of household, and $125k for married filing separately)

As these examples illustrate the tax increases, they only detail the impact of the increase in Medicare taxes. By some estimates, if the current tax cuts expire at the end of the year, many couples in Bob and Cathy's income level could face an overall increase of household taxes by $25,000-$30,000.

Although we are uncertain of what the final tax situation will be in 2013, there are still two important tax strategies to consider in minimizing taxes in any tax environment:

- **Use Tax Efficient Investment Vehicles**
- **Employ Tax Deferral and Tax Exclusion Strategies**

(Continued on back)

Below is a chart that summarizes the concept of different levels of tax efficiency in investment vehicles.

HIGH

Individual Stock / Bond Portfolio
(Customized & Actively Managed)

Pros: Tax efficient, Diversified, Transparent
Cheaper than Mutual Funds
Stronger long term performance
Cons: Not suitable for small accounts

Annuity Contracts

Pros: Deferred tax , Available to small accounts
Cons: Low tax efficiency
Surrender term, Many charges, Layers of fees
Not transparent, Complicated

Mutual Funds (MFs)

Pros: Diversification
Good for small accounts
Cons: Not tax efficient, Expensive
Not transparent, Weak performance
No support

Exchanged Traded Fund (ETFs)

Pros: Diversification
Good for small accounts
Cheaper than Mutual Funds
Cons: Not tax efficient, Not transparent
Index performance, No support

LOW

Both Mutual Funds and Exchange Traded Funds are **not** considered tax efficient investments – simply because individual investors are only a small portion in a big pool of funds. The tax concerns of individual investors will not be considered when fund managers make buy/sell and distribution decisions. This is the reason why, in some instances, even a fund that is losing money could still cause investors to receive 1099 capital gains for tax reporting.

Annuities are slightly better because they are tax deferred vehicles and can be used after all other retirement plan contributions have been maxed out in the current year. However, some of the biggest **drawbacks of investing in annuities are the costs associated with early withdrawals and their inclusion in the estate.** Disbursements from the annuity will be taxed at the ordinary income tax rate which is higher than the capital gains tax rate, and there is no step up in cost basis when the annuity contract passes to a beneficiary. One option for investors who currently own low-performing annuities with high expense ratios, and who want to avoid paying excess taxes, is to use a 1035 exchange for a lower expense annuity contract with no surrender charges and more flexible terms.

An individual stock and bond portfolio is one of the most tax efficient investment vehicles. It can be customized and executed based on the investors' specific tax considerations. An individual portfolio can determine the optimal time to harvest gains or losses, strategically utilize the wash sale rule, and institute income shifting or gifting techniques to further lower taxes.

In addition to using tax efficient investment vehicles, an investor should consider tax deferral and exclusion techniques. The goal is to find a way to minimize the exposure to the income tax, capital gains tax, and potential estate tax.

Regardless of the investor's occupation and employment situation, **it is important to max out the contribution limits on retirement plans**. The money placed in retirement accounts grows tax deferred and also reduces adjusted gross income in calculating current taxes. Note that the current contribution limit on a qualified defined benefit plan is $200,000.

For retirees, a judicious use of partial Roth IRA conversions based on estimated tax levels can also be beneficial. Qualified distributions from a Roth are tax free and not considered as part of Modified AGI in the above mentioned Medicare Surtax calculation. **Having both a Traditional and Roth IRA provides greater flexibility in dealing with changing tax rate environments**.

Lastly, advanced estate planning techniques such as Charitable Remainder Trusts, Private Foundations, and Donor-Advised Funds are good tools to avoid income tax, eliminate capital gains tax, and future estate tax. These are commonly used by families with highly appreciated properties and a desire to build a legacy of charitable giving for the family. Another option for wealth transfer is an outright gift with the current year's gift exemption amount still at $5 million that is likely to be reduced in 2013. Many specially drafted trusts such as an Intentionally Defective Grantor Trust (IDGT), Grantor Retained Annuity Trust (GRATs) and other irrevocable trusts could also save a significant amount in federal and state taxes. However, **suitability and cost/benefit analysis on all these planning techniques should be carefully evaluated before being employed.**

Tax planning continues to be an important element of comprehensive wealth management planning. As with all tax and planning advice, investors should consult with a qualified professional before implementing strategies. ***We at Pillar Pacific Capital Management are here to provide a total wealth management and planning solution which is customized to your needs.***

Our vision is to provide sound financial management for each client, always placing the best interests of the clients first. We aim to preserve and enhance every client's wealth while providing peace of mind and financial security, now and for future generations.