HAWK Talon

HAWK 100

Monthly News from Hawk100 Issue 24, December 2010

A taxing valuation exercise.

Before the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act, taxes were set to rise incrementally by 24.1% on dividends and 5% on capital gains. The Act defers rate hikes until after 2012 at the earliest.

The S&P 500 Index rose 6.7% during December. Hawk100 suspects that much of the rise attributes to extended tax cuts. The following briefly examines whether the market fairly priced tax Act effects.

The S&P 500 Index opened December at 1181 and at December 31 was priced to yield 1.8% in dividends and consensus growth estimates were 9.9%.

The foregoing figures are before taxes. With the foregoing, pretax dividends would be $21 and $23 for 2011 and 2012. The index would rise 120 and 132 points for an ending capital gain of $252.

Had taxes been allowed to incrementally rise, dividends would have been lower over the next two years by $11 after tax. Also, gains would have been reduced by $13 after tax. The incremental expected return would be $24 undiscounted, or 2%, which fails to justify the strong month.

Though this analysis is simplified, it suggests caution that stocks may have overreacted to new tax provisions.

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Two more years! Two more years!

2011 Federal Tax Rate Tables

Tax rate	Single	Married joint	Married separate	Head of household
	Applied to income in excess of:			
10%	-	-	-	-
15%	8,500	17,000	8,500	12,150
25%	34,500	69,000	34,500	46,250
28%	83,600	139,350	69,675	119,400
33%	174,400	212,300	106,150	193,350
35%	379,150	379,150	189,575	379,150

SOURCE: IRS Revenue Procedure 2011-12

Promotion of the recent tax act reminds Hawk100 of the cheer commonly heard from faithful followers of whatever political party holds power. Obama and democrats appeared uncomfortable while cheering for two more years of previously derided “Bush tax cuts.” Hawk100 applauds their recognition, at last, that potential tax hikes limit economic activity and that preserving lower rates while clarifying rules (at least through 2012) helps stabilize a frail economy. Now that both parties own prevailing policy, let’s hope Beltway insiders stop deriding “failed Bush policies of tax cuts for the rich.”

The Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act—signed into law December 17—affects more than the sunset date on tax rates. Relevant provisions according to the AICPA, are as follows.

Individual income taxes. The Act temporarily eases the tax burden for individuals. For 2011, the Act reduces employee FICA tax from 6.2 to 4.2% (for self employed, FICA drops from 12.4% to 10.4%), extends the deductibility of state and local sales taxes, and continues to make charitable distributions from IRAs tax exempt. Through 2012, the Act continues relief from the marriage penalty as well as credits for adoption, dependent care, refundable child, and earned income. Long-term capital gains and qualifying dividends will continue to be taxed a maximum rate of 15%.

The Act makes another Alternative Minimum Tax “patch” for 2010 retroactively and for 2011 prospectively. AMT exemption amounts rise slightly, and personal nonrefundable tax credits may offset AMT liability.

Estate and gift taxes. The Act creates a $5 million estate tax exemption and 35% rate retroactively effective as of January 1, 2010. For 2010 estates, executors can elect to opt out of the estate tax and back into carry over basis. In analyzing whether to opt out, be mindful of the portion of estate value attributable to unrealized appreciation.

The Act reunifies gift (and generation skipping transfer) tax with the estate tax with a $5 million exemption and 35% rate. Surviving spouses may use estate and gift exemptions that went unused by a deceased spouse. In 2013, gift (and GST) tax rules revert back to 2001 provisions ($1 million exemption and 55% rate).

Business taxes. Numerous provisions extend tax relief for businesses. Through 2011, the Act extends the no ”net-income limitation” for depletion on marginal oil and gas wells, and extends credits for R&D and for purchases of energy efficient home improvements but reduces the lifetime credit from $1,500 to $500.

The Act allows businesses to deduct 100% of the cost of property acquired and placed in service between September 8, 2010 and January 1, 2012 and 50% of 2012 property. The Act also extends the election to accelerate AMT credits instead of bonus depreciation through 2012, but property that was manufactured, constructed or produced during 2010 is ineligible. 2012 section 179 expensing limit will be $125,000 and the phase-out threshold will be $500,000 then reduced for years after 2012 to $25,000 and $200,000, respectively.

Hawk100 welcomes discussions with members with respect to how the Act affects the alignment of your wealth with your life. HawkHunt members may do so with our compliments while HawkNest members may incur additional fees.

By Richard Clemens, CFA, President