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Wealth and Taxes: Planning for 2014

2013 YEAR-END TAX PLANNING GUIDE

On January 1, 2013, Congress passed the American Taxpayer Relief Act (ATRA), which addressed the scheduled expiration of the so-called Bush tax cuts.

While ATRA prevented income tax increases for most taxpayers, taxpayers with higher incomes were not so lucky, and their income tax rates for 2013 and 2014 have increased. Adding to this higher tax burden are higher Medicare taxes on earned and investment income. On the other hand, ATRA made permanent the elevated estate, gift, and generation skipping tax exemptions of $5 million in 2011, indexed for inflation in subsequent years.

While the changes made by ATRA are "permanent," they are still subject to future legislative changes, which can occur in any year. Smart tax planning, therefore, is prudent in ANY tax environment. In this planning guide we have outlined a number of strategies that are available to investors. Your Morgan Stanley Financial Advisor or Private Wealth Advisor can work with you and your tax professional to help determine strategies that may be beneficial to you.

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Beyond the Fiscal Cliff: Certainty or Uncertainty in Tax Policy?

In recent years, we have seen a greater tendency for last-minute decisions on economic policy legislation in Washington. ATRA was passed at the last hour (some would say after the last hour). More recently, debt ceiling and budget legislation, each of which can directly or indirectly have an effect on tax policy, also passed at the last hour, and in some cases a permanent resolution has simply been delayed. Adding to this legislative and policy uncertainty are other significant issues that could affect the economy, such as the Affordable Care Act, economic and political conditions in other countries, and foreign policy issues. These issues make it hard to expect anything other than continued uncertainty in coming years with respect to tax policy, especially when it comes to high earners.

What is certain, however, is that in 2013 and 2014, higher income taxpayers will pay an additional 3.8% Medicare Investment Income Tax on their investment income and a 0.9% higher Medicare tax on compensation; the addition of the Medicare Investment Income Tax results in a top effective tax rate of 43.4% on dividends, interest, and short-term capital gains and 23.8% for qualified dividends and long-term capital gains. The estate tax, with a new slightly higher rate of 40%, has a new "permanent" exemption of $5 million (2011 dollar-indexed for inflation), increasing it to $5.25 million in 2013 and $5.34 million in 2014.

Tax Rates Effective in 2013 and 2014

Taxable Income Ranges (Married Filing Jointly)		Income Tax Rates
2013	2014 (Projected)	2013-2014
Over $450,000	Over $457,600	39.6%
$398,350 – $450,000	$405,100 – $457,600	35%
$223,050 – $398,350	$226,850 – $405,100	33%
$146,400 – $223,050	$148,850 – $226,850	28%
$72,500 – $146,400	$73,800 – $148,850	25%
$17,850 – $72,500	$18,150 – $73,800	15%
$0 – $17,850	$0 – $18,150	10%
Top effective dividend rate (nonqualified)[1]		43.4%
Top effective dividend rate (qualified)[1]		23.8%
Top effective long-term capital gains rate[1]		23.8%
Estate tax rate		40%
Estate & gift tax exemption		$5.25M in 2013 and $5.34M in 2014

Source: IRS

[1] Includes Medicare Investment Income Tax of 3.8%

Ten Strategies for Navigating an Uncertain Landscape

Prudent investing should include a review of one's investments to help ensure that they are meeting stated financial objectives. With markets changing daily and political pressures and policies affecting the economy, investors should consider being even more vigilant in reviewing and adjusting their assets, allocation and overall portfolio strategy to keep investments aligned with goals.

2013 Retirement Plan Contribution Limits

Type of Plan	Under Age 50	Age 50 or Older
Traditional / Roth IRA[2]	$5,500	$6,500
401(k)/403(b)/457(b)/SAR-SEP[3]	$17,500	$23,000[4]
SIMPLE	$12,000	$14,500[4]

[2] Contributions to an IRA are dependent upon your age, earned income and access to an employer-sponsored retirement plan.

[3] Only SAR-SEP plans established before 1997 may allow employees to make pre-tax contributions.

[4] If permissible under the terms of your employer-sponsored retirement plan.

1. MAX OUT RETIREMENT PLANS.

In any tax environment, it might make sense to fully fund your company retirement accounts and/or IRAs. One of the primary advantages of participating in a Traditional IRA, or an employer-sponsored retirement plan such as a 401(k), is that the money you contribute in a given year may be tax deductible. If your taxable income is less, the amount of income tax you owe for that year might also be reduced. And because these are tax-deferred accounts, you do not pay income taxes on any earnings on your investments until you withdraw funds. You have until April 15, 2014 to fund your IRA for 2013. Consult your employer and tax advisor to determine the deadline for contributing to your company retirement plan.

2. CONSIDER A ROTH IRA CONVERSION.

While income limits may preclude some investors from contributing to a Roth IRA, anyone can do a Roth Conversion by converting eligible funds from a Traditional IRA or employer-sponsored retirement plan to a Roth IRA. (Roth IRA contributions are made with after-tax dollars, and qualified withdrawals in retirement are tax free.[1] When you convert, you must pay taxes on the amount converted as ordinary income for that year.) Taxpayers who have potentially taxable estates should seriously consider the Roth IRA conversion option, as it could make a potentially significant future wealth transfer more tax efficient.

3. REVIEW HIGHLY APPRECIATED ASSETS.

Even though the capital gains tax rates have increased for high income taxpayers, the capital gains rates for most taxpayers are still significantly less than ordinary income tax rates. Consult your Morgan Stanley Financial Advisor or Private Wealth Advisor and your tax advisor about whether shifting to investments that generate capital gains instead of ordinary income would be a good strategy for you.

4. GIVE INCREASED ATTENTION TO BUY-AND-HOLD STRATEGIES.

If the tax rate on capital gains increases, the tax benefits of buy-and-hold strategies can become more valuable. Similarly, it becomes more important to harvest tax losses in order to shelter gains that otherwise would be taxed at the higher rate.

Equity unit investment trusts (UITs) are generally unmanaged investments with holding periods ranging from 15 months to five years that can help increase your tax efficiency since there are less short-term capital gains because the underlying securities are bought and held.

[1] Restrictions, penalties and taxes may apply. Unless certain criteria are met, Roth IRA owners must be 59 ½ or older and have held the Roth IRA for five years before completely tax/penalty-free withdrawals are permitted.

5. AUGMENT YOUR TAX-ADVANTAGED INVESTMENTS WITH MUNICIPAL BONDS.
Municipal bonds, which are typically federally tax-free and generally free from state and local taxes, are one of the most efficient investments available for defending against current and potentially higher tax rates. Even though income tax rates rose for high income taxpayers, interest income earned on municipal bonds remains largely unaffected. Because there is a wide range of state-specific issues, credit ratings and maturities from which to choose, be sure to work with your Morgan Stanley Financial Advisor or Private Wealth Advisor when adding exposure to this asset class.

6. CONSIDER REDEPLOYING ASSETS TO A VARIABLE ANNUITY.
In a rising tax environment, the tax-deferral feature of annuities becomes increasingly valuable. Diversifying your retirement portfolio with a variable annuity can provide tax-deferred growth potential, guaranteed lifetime income, increased retirement savings, equity upside potential and a death benefit for named beneficiaries. Remember, though: withdrawals from variable annuities will be taxed as ordinary income.

Guiding principle: It's not what you earn; it's what you keep. Therefore, it's always appropriate to consider the range of tax-free, tax-deferred and tax-advantaged investment strategies.

7. CONSIDER PROFESSIONALLY MANAGED AND TAX-ADVANTAGED INVESTMENT STRATEGIES (OR THE USE OF TAX-OPTIMIZATION STRATEGIES FOR MANAGED ACCOUNTS).
Now is a good time to evaluate the overall tax efficiency of investments in your accounts. Beyond municipal bonds, consider tax-efficient mutual funds or separately managed accounts ("SMAs") that are managed to limit the number of taxable events within your portfolio. These may include tax-managed funds and tax-exempt or low turnover index funds with minimal capital gains distributions. Other options may also include SMAs that limit tax exposure through tailored individual holdings and tax rates, and those that employ tax management techniques that seek to reduce the impact of taxes and increase your after-tax return potential. Lastly, within Select UMA (Unified Managed Account) consider our optional tax management feature that builds on the tax advantages inherent in SMAs utilizing tax-loss harvesting and other techniques to help manage tax liabilities at the portfolio level.

Exchange Traded Funds (ETFs) generally pass through lower short-term capital gains because investor shares are traded on an exchange resulting in lower portfolio turnover. These types of funds can help blunt the effects of any future increases in taxes and capital gains rates.

8. REVIEW DIVIDEND DISTRIBUTIONS OF YOUR CURRENT PORTFOLIO.
Qualified dividend income tax rates for most taxpayers remained the same with the passage of ATRA. However, for higher income taxpayers, the new 3.8% Medicare surtax has effectively increased the qualified dividend top tax rate to 23.8%. These rates are still lower than the ordinary income tax rates for most taxpayers, so consult with your Morgan Stanley Financial Advisor or Private Wealth Advisor and your tax advisor about whether you should adjust your investment holdings to achieve greater income tax efficiency.

9. ENGAGE IN LEGACY PLANNING AND GIFTING.
Even though the estate and gift tax exemptions were made permanent and adjusted for inflation under ATRA, all clients, regardless of their level of wealth, should have an estate plan in place that reflects their current end-of-life wealth transfer goals and objectives. Taxpayers with taxable or potentially taxable estates who desire to leave an estate to their heirs should consider making lifetime gifts to heirs now to potentially achieve more tax efficient wealth transfer.

10. FOCUS ON YOUR GOALS FIRST.
Don't let the tax tail wag the dog! As critical as it may be to understand the potential effects of possible tax increases, it is even more important not to make tax planning the sum total of your planning. First and foremost, you should focus on what you want most for yourself and your family now and in the future. Keeping those primary objectives always in the forefront, turn to your Financial Advisor or Private Wealth Advisor to see how you can best achieve them in the most tax efficient manner.

Gifting and Legacy Planning

You are entitled to transfer up to $14,000 per recipient in 2013 and 2014 without incurring any federal gift tax. This is an annual exclusion that is in addition to the lifetime exemption amount of $5.25 million in 2013 and $5.34 million in 2014. Spouses together may gift up to $28,000 per recipient annually in addition to their lifetime exclusion (the annual exclusion amount is separate from the one-time gift and estate tax exemption, and is not scheduled to change next year). You can create and fund an irrevocable life insurance trust, or ILIT, with annual gifts to the trust, thereby maximizing the benefits of the annual gift tax exclusion. In addition, you can use all or some of your lifetime exemption to buy additional insurance to further leverage your gift.

Consider an "accelerated" gifting strategy for your 529 college savings plan contributions to help fund a loved one's higher education and potentially reduce your taxable income and your taxable estate – without giving up control of your assets. There is a special provision in the tax code that allows you to take five years of gift tax exclusions in a single year – up to $70,000 ($140,000 for a married couple), for each beneficiary – by making a contribution into a 529 plan.[1]

Consider charitable gifts of appreciated stock and other illiquid assets. As long as the investment has been owned for at least one year and has appreciated in value, the owner may deduct the full market value without having to pay tax on the appreciation. A donor advised fund (DAF), such as Morgan Stanley Global Impact Funding Trust (GIFT), is a tax-efficient way of donating taxable stock, mutual funds or other appreciated assets. A tax deduction can be claimed for the entire market value of the donated assets. A DAF can be funded in years when the deduction will have the most impact, and distributions can be made in later years without consideration of the tax consequences.

Conduct a beneficiary review with your Financial Advisor or Private Wealth Advisor and legal advisor to ensure that your estate plans, trusts, insurance contracts and retirement accounts are complete, up-to-date and reflective of your current desires.

[1] No further annual exclusion gifts and/or generation-skipping transfers to the same beneficiary by the donor may be made over the same five-year period, and the gift must be reported as a series of five equal annual gifts. If the donor dies within the five-year period, a portion of the gifted amount will be included in the donor's estate for estate tax purposes. If you revoke the account, its value comes back into your taxable estate.

Case Study

What Do the New Tax Laws Mean to You?

Steve and Robin Green are a hypothetical couple with three children. In each of years 2012 through 2014 they will earn $500,000 in wages, plus an additional $315,000 from non-qualified stock options and investment income. They are in the top tax bracket, which this year is 39.6%. Working with their tax advisor last year, they used various deductions and exemptions to reduce their taxable income to $698,000. As a result, the Greens paid just over $183,000 in federal taxes for 2012.

After ATRA, the Greens' tax picture will be quite different in 2013 and 2014:

- Their tax rate increases from 35% to 39.6%.
- The rate they pay on long-term capital gains rises from 15% to 20%.
- They are subject to the 3.8% Medicare Investment Income tax and 0.9% Medicare Wage taxes as a result of their high income (which applies to all capital gains, dividends and interest, and which increases the effective long-term capital gains tax rate to 23.8%).
- Because of their high income, their personal exemptions are eliminated, and their itemized deductions are reduced.

In short, the Greens will owe an additional $36,176 in taxes in 2013 and 2014—even though their income has not changed. That's a 19.7% increase, some of which may have been avoided with careful tax planning.

The strategies discussed previously in this brochure might help minimize the impact of potential tax law changes projected for next year. Contact your Financial Advisor or Private Wealth Advisor to determine which ones might be appropriate for you.

Put it all together and here's how Mr. and Mrs. Green's tax liability will look in 2013 and 2014 vs. 2012.

INCOME	**2012**	**2013-2014**	
Wages	$500,000	$500,000	
Non-Qualified Stock Options	$100,000	$100,000	
Interest Income	$25,000	$25,000	
Qualified Dividends	$50,000	$50,000	
Short-Term Capital Gains	$40,000	$40,000	
Long-Term Capital Gains	$100,000	$100,000	
Adjusted Gross Income	$815,000	$815,000	A
DEDUCTIONS			
Less Itemized Deductions	-$98,000	-$82,550	B
Less Exemptions	-$19,000	$0	C
Taxable Income	$698,000	$732,450	
TAXES			
Regular Tax	$160,940	$176,094	D
Qualified Dividends	$7,500	$10,000	E
Long-Term Capital Gains	$15,000	$20,000	F
New Medicare Investment Income Tax		$8,170	G
New Medicare Wage Tax		$3,150	H
Medicare Wage Tax		$2,202	I
US Tax Liability	$183,440	$219,616	

Hypothetical example for illustrative purposes only

A. The Greens' income remains the same

B. Higher income families see a reduction in their itemized deductions

C. These families also lose their personal exemptions

D. Reflects an increase in the tax rate from 35% to 39.6%

E. Qualified dividends, currently taxed at 15%, are taxed at a rate of 20%. (See G below)

F. Raised from 15% to 20% (See G below)

G. Joint filers with an AGI over $250k ($200k for single filers) incur a new tax of 3.8% on interest, dividends, and all capital gains, and which increases the effective tax on qualified dividends and long-term capital gains to 23.8%.

H. They also incur an additional Medicare Wage tax of 0.9%

I. 2% Social Security payroll tax reduction (6.2% vs. 4.2%) returns in 2013

Checklist

Ten Strategies for Navigating an Uncertain Landscape

STRATEGY TO CONSIDER	NEXT STEPS
☐ Max out retirement plans	
☐ Consider a Roth IRA conversion	
☐ Review highly appreciated assets	
☐ Give increased attention to buy-and-hold strategies	
☐ Augment your tax-advantaged investments with municipal bonds	
☐ Consider redeploying assets to a variable annuity	
☐ Consider professionally managed and tax-advantaged investment strategies (or the use of tax-optimization strategies for managed accounts)	
☐ Review dividend distributions of your current portfolio	
☐ Engage in gifting and legacy planning	
☐ Focus on your goals first	

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Companies paying dividends can reduce or cut payouts at any time.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. NOTE: High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Mutual Funds, Exchange Traded Funds (ETFs), Unit Investment Trusts (UITs) and Variable Annuities are sold by prospectus. Investors should carefully read the prospectus which includes information on the investment objective, risks, charges and expenses along with other information before investing. To obtain a prospectus, please contact your Financial Advisor. Please read the prospectus carefully before investing.

Variable annuities are long-term investments designed for retirement purposes and may be subject to market fluctuations, investment risk, and possible loss of principal. All guarantees are based on the claims-paying ability of the issuing insurance company. Taxable distributions (and certain deemed distributions) are subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal income tax penalty. Early surrender charges may also apply. Withdrawals will reduce the death benefit and cash surrender value. Variable annuities are subject to market risk, will fluctuate in value and can lose money.

If you are investing in a variable annuity through a tax-advantaged retirement plan such as an IRA, you will get no additional tax advantage from the variable annuity. Under these circumstances, you should only consider buying a variable annuity because of its other features, such as lifetime income payments and death benefit protection.

Insurance products are offered in conjunction with Morgan Stanley's licensed insurance agency affiliates.

Investors should consider many factors before deciding which 529 Plan is appropriate. Some of these factors include: the Plan's investment options and the historical investment performance of these options, the Plan's flexibility and features, the reputation and expertise of the Plan's investment manager, Plan contribution limits and the federal and state tax benefits associated with an investment in the Plan. Some states, for example, offer favorable tax treatment and other benefits to their residents only if they invest in the state's own Qualified Tuition Program. Investors should determine if their home state offers a 529 Plan that may offer such favorable tax treatment and benefits to residents or beneficiaries of that state that may not be available to investors or beneficiaries of other states. Investors should consult with their tax or legal advisor before investing in any 529 Plan or contact their state tax division for more information. Morgan Stanley does not provide tax and or legal advice.

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