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August 2010

Quarterly Newsletter



Will You See Higher Tax Rates in 2011?

The year was 2001. The top marginal federal income tax bracket was 39.6%, and the tax rate that applied to most long-term capital gains was 20%. Then came the Economic Growth and Tax Relief Reconciliation Act of 2001, followed two years later by the Jobs and Growth Tax Relief Reconciliation Act of 2003. By mid-2003, the top marginal tax rate was 35%, and the 20% capital gains rate had dropped to 15%. But this tax relief was designed to be temporary—the provisions that established lower rates were crafted to self-expire after a period of time. And now, in 2010, we're only months away from seeing those provisions expire.

Federal income tax brackets

Right now, there are six marginal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. For 2010, these brackets apply to married couples filing joint federal income tax returns in the following manner:

2010 MARGINAL INCOME TAX BRACKETS	
<i>MARRIED FILING JOINTLY</i>	
Taxable Income	Marginal Tax Rate
Not over \$16,750	10%
Over \$16,750 to \$68,000	15%
Over \$68,000 to \$137,300	25%
Over \$137,300 to \$209,250	28%
Over \$209,250 to \$373,650	33%
Over \$373,650	35%

As it stands now, these marginal tax brackets will expire at the end of 2010. There would be no 10% bracket for 2011, and the remaining bracket rates would return to their original 2001 levels: 15%, 28%, 31%, 36%, and 39.6%.

Long-term capital gain tax rates

For 2010, if you sell shares of stock that you've held for more than a year, any gain is long-term capital gain, generally taxed at a maximum rate of 15%. If you're in the 10% or the 15% marginal income tax bracket, however,

you'll pay no federal tax on the long-term gain (a 0% tax rate applies). That means if you're a married couple filing a joint federal income tax return, and your taxable income is \$68,000 or less, you'd pay no federal tax on the gain.

However, these rates are also scheduled to expire at the end of 2010. Absent new legislation, in 2011, a 20% rate will generally apply to long-term capital gains. Individuals in the 15% tax bracket (remember, there won't be a 10% bracket in 2011) will pay the tax at a rate of 10%. Special rules (and slightly lower rates) will apply for qualifying property held for five years or more.

Finally, while qualifying dividends are taxed in 2010 using the same capital gain tax rates described above (i.e., 15% and 0%), in 2011 they'll be taxed as ordinary income.

Will Congress take action?

In the proposed 2011 budget submitted to Congress in February, President Obama asked for a permanent extension of the current 10%, 15%, and 25% marginal income tax brackets, and an expansion of the current 28% tax bracket. The current 33% and 35% brackets would be allowed to expire, resulting in the top two marginal rates for 2011 returning to 36% and 39.6%. The expanded 28% bracket would be calculated in a way that would allow individuals earning less than \$200,000 (less the standard deduction amount and one exemption) and married couples filing jointly earning less than \$250,000 (less the standard deduction and two personal exemptions) to escape taxation at the top rates.

The President also proposed making the current tax rates that apply to long-term capital gain (i.e., the 0% and 15% rates) permanent, but adding a new 20% rate for those in the newly reestablished 36% and 39.6% brackets.

Will Congress act, or will it simply let current rates expire? There's plenty of time before 2011, so stay tuned.

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Investment Outlook Summary

ASSET CLASS	OUTLOOK	OBSERVATIONS
Cash / Stable Value	<ul style="list-style-type: none"> – Maintaining minimal levels of cash 	Because of low yields and the low interest rate environment we're currently maintaining low balances of cash.
Bonds / Fixed Income	<ul style="list-style-type: none"> – Positive on bonds – Cautious of U.S. Treasuries – Positive on short-term high-quality corporate debt – Positive on floating rate – Positive on emerging market bonds 	<p>In general, bonds provide a relatively steady stream of income and a higher degree of safety compared to the stock market.</p> <p>Currently we are at historic lows in interest rates. At some point in the near future we believe the Fed will begin to raise rates to fight inflation which makes Treasuries even less attractive.</p> <p>The default risk associated with high grade corporate debt is low at this time. Short-term corporate debt is also less prone to interest rate risk than Treasuries.</p> <p>Because of their short maturity dates, their yields adjust more quickly in a rising interest rate environment.</p> <p>As emerging markets strengthen, their bonds become more attractive and are hedged the U.S. Dollar as well.</p>
Stocks / Equities	<ul style="list-style-type: none"> – Currently underweight in stocks – Positive on dividend-paying stocks – Positive on Consumer Staples – Positive on Infrastructure-related stocks – Positive on alternative energy – Real estate stocks show opportunities – International stocks show value 	<p>With unemployment at current rates we are cautious of equities.</p> <p>As the market continues to trade sideways, high-quality dividend-paying stocks present opportunities to get paid while we wait for the market to fully recover.</p> <p>Consumer Staples tend to be fairly more recession resistant than other equities. Regardless of current economic conditions, people still purchase from Consumer Staple orientated companies in order to take care of their basic needs.</p> <p>Because of the recent stimulus package and the money set aside specifically for infrastructure spending, we have a positive outlook on this area.</p> <p>The current administration has very favorable policies towards alternative energy.</p> <p>We feel there is long term opportunity because of the recent commercial and residential real estate bubble.</p> <p>International stocks are a good long-term hedge against the U.S. Dollar and the stock market.</p>
Alternate	<ul style="list-style-type: none"> – Positive on foreign currencies – Positive on energy trusts – Positive on oil – Positive on natural gas – Cautious on gold 	<p>With record high U.S. deficits, foreign currencies are a hedge against a falling U.S. Dollar.</p> <p>Because of the high dividends energy trusts tend to pay, they are a good way to help alleviate some of the stock market's volatility.</p> <p>As the global economy rebounds, and the demand for autos in emerging markets increases, we feel that the demand for oil will continue to rise.</p> <p>It's an energy source that is highly abundant in the U.S. and can be looked at as a way to help decrease our dependence on Middle Eastern oil.</p> <p>Due to the record high prices we are concerned with the decreased upward mobility with gold at this time.</p>

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