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Third Quarter 2012

Guide...Protect...Preserve

Discover "Hidden" Tax Break For Company Stock

Are you eligible to purchase your company's stock through a stock bonus plan or via employee stock options, using funds in your 401(k) or other qualified retirement plan? If the company's prospects look good, you may jump at the chance, especially if you can acquire the stock at a discounted price and you're in a position to help improve the corporate fortunes. If you eventually sell the stock after the shares have increased in value, you can realize a tidy profit.

But here's some practical advice you may find surprising: Try not to sell the stock before you retire. Instead, when you're ready to receive distributions from your retirement plan, arrange to take a payout in the form of company stock. Thanks to a little-known tax break, you can avoid tax on the stock's appreciation during the time you've owned it.

The basic premise is that if you receive a retirement plan payout in the form of company stock after a "qualified triggering event," your tax will be based on the initial cost of the stock. Any increase in the value of the stock from the time you acquired it—an amount known as "net unrealized appreciation" (NUA) in tax lingo—will be completely exempt from tax. That's in sharp contrast to other distributions from qualified retirement plans, which are generally taxed at ordinary income rates as high as 35% this year (and scheduled to increase to a top rate of 39.6% in 2013).

But the tax breaks don't stop there. If and when you finally sell the stock that you take as a retirement plan distribution, any gain from the sale is treated as a capital gain—and if it qualifies as a long-term gain (if you've owned the stock longer than one year), the maximum tax rate is currently 15% (scheduled to increase to 20% in 2013).

To qualify for the NUA tax break, a distribution must be:

- Made from a tax-qualified employer retirement plan (IRAs don't qualify);
- Due to a triggering event such as death or disability, reaching age 59½, or leaving a job; and
- Made in a single tax year (usually as a lump-sum distribution).

Be careful. For example, if you take a lump-sum distribution of your entire plan balance and your company then adds a late contribution or makes some other adjustment after the close of the tax year, the distribution will lose its favored tax status.

Of course, there are investment considerations here as well as the tax aspects. It's important for your 401(k) account, like any other portfolio, to be adequately diversified. Don't make the mistake of having all your funds invested in company stock. Still, having some of your assets in the shares of your company could be undeniably appealing.

Suppose that during your 25 years with the company you acquired 20,000

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Volatile Markets Offer Opportunity And Risk Alike

After the roller-coaster ride of 2011, stock markets worldwide have turned in a more settled performance so far this year. However, many analysts predict volatility will return soon as the outlook for Europe and the United States starts to fluctuate.

Stock market volatility often results from economic uncertainty. When investors believe the economy is on the upswing, strong buying sentiment tends to send prices higher. But an adverse geopolitical event or economic trend can spark a wave of selling that sends prices down fast.

Long-term investors generally need to try not to react to short-term market fluctuations. And while it may be prudent to rebalance more often when conditions are volatile, the best way to cope is to develop a diversified portfolio with a mix of assets that tend not to move in sync over longer periods. Investing in bonds, equities, and alternative assets may smooth out the ups and downs of portfolio as a whole. But it's important to diversify within asset classes, too—with growth and value stocks; large-, mid-, and small-cap stocks; and domestic, international, and emerging-markets stocks.

It's easier than ever to achieve such diversity, because mutual funds and exchange-traded funds have made hedge-fund strategies and foreign stocks more accessible. We can guide you in choosing the right investment vehicles to match your goals and risk tolerance.

Mary Jane Callaghan & Mitch Glicksman

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What Are The 401(k) Limits In 2012?

The 401(k) plan continues to be, by far, the most popular company-sponsored retirement plan in the land. And it's no wonder. This unique retirement-saving vehicle offers tax advantages to employees and can also be a valuable tool for employers looking to recruit and retain top talent.

The basic premise is simple: You arrange to have a portion of your pre-tax salary deposited in a separate account. Frequently, an employer will agree to match each dollar that plan participants contribute, up to a specified percentage of compensation. For example, if you earn $100,000 and put $10,000 a year into your 401(k), your company, providing a 3% match, would kick in another $3,000 annually.

There's no current tax on investment earnings within the account, though you also don't get to claim a deduction for losses. Distributions from the account, usually during retirement, are taxed at ordinary income rates. If you change jobs or retire, you normally can choose among keeping the money in your old company's plan, shifting it to a new 401(k), or rolling over some or all of the account to an IRA.

That's the short story. But there are numerous other legal limits and restrictions to contend with. One of the biggest is the annual limit on how much salary you can defer, a number that rises based on an inflation index. Furthermore, the plan must satisfy strict, complex nondiscrimination requirements.

How well do you know the current rules? See how you fare on this brief quiz.

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1) The maximum amount an employed 45-year-old can contribute to a 401(k) in 2012 is:

a) Zero.
b) $17,000.
c) $21,500.
d) $22,500.

2) The maximum amount an employed 55-year-old can contribute to a 401(k) in 2012 is:

a) Zero.
b) $17,000.
c) $21,500.
d) $22,500

3) The maximum amount a retired 65-year-old can contribute to a 401(k) in 2012 is:

a) Zero.
b) $17,000.
c) $21,500.
d) $22,500.

4) The minimum number of employees required to establish a 401(k) plan is:

a) 1.
b) 10.
c) 25.
d) 100.

5) If you aren't a company's owner, you must begin taking distributions from its 401(k) plan:

a) At age 59½.
b) At age 70½.
c) When you retire.
d) At age 70½ or your retirement date, whichever comes later.

6) A rollover from a 401(k) plan to an IRA is subject to a 20% withholding tax unless:

a) You complete the rollover within 60 days.
b) You arrange a trustee-to-trustee transfer.
c) You retire before the end of the tax year.
d) You are under age 59½.

7) If you receive a $10,000 "hardship distribution" from a 401(k) in 2012 and you're in the 25% tax bracket, your income tax liability is:

a) Zero.
b) $1,000.
c) $2,500.
d) $3,500.

Answers: 1-b; 2-d; 3-a; 4-a; 5-d; 6-b; 7-c

Start Harvesting Gains In 2012

If you're in the same tax boat as most other investors, you should start thinking about harvesting capital gains from securities sales in 2012.

That's right—harvesting gains, not losses. The normal advice is to look for valuable tax losses, especially at the end of the year, that you can use to offset capital gains as well as up to $3,000 of ordinary income. (You can carry over excess losses to the following year.)

But this year is different. The current maximum tax rate of 15% on long-term capital gains—realized on the sale of securities you've held longer than a year—is scheduled to increase to 20% in 2013. Furthermore, the tax rate for short-term gains (from the sale of assets held one year or less) will also rise, especially for high-income investors. Short-term gains are taxed at ordinary income rates that currently reach no higher than 35%. Beginning in 2013, however, the top rate for ordinary income is set to rise to 39.6%. Next year you may also be subject to a 3.8% Medicare surtax that will apply to net investment income if you exceed a specified threshold.

Congress could still act to preserve some or all of the lower tax rates, but even if that happens, it probably won't be until after the November elections. Therefore, the optimal approach, at least for now, is to focus on the current tax benefits of selling stocks that have appreciated significantly during the time you've owned them. If you believe those shares are likely to continue to increase in value, it probably makes sense to hold on to them and not to worry about future tax consequences. But if the outlook for future gains is uncertain, you might want to take advantage of today's favorable tax treatment of long-term capital gains.

Let's suppose, hypothetically, that you're holding a stock position you

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Recent Downturn In Equities Is Temporary

After a sizzling start this year, the stock market took a breather in April and May. The early rally in equity markets, coming alongside tentatively optimistic news about jobs, housing, and the economy at large, seemed to suggest that the slow recovery of the past few years finally was gaining momentum. But now that the major stock benchmarks have stumbled, many investors are worried that, once again, the economy's advance may slow to a crawl.

So which is it? Does the recent dip reflect deeper problems? Or is it merely a reasonable pause before stocks resume their surge?

If you consider what happened during the first quarter, it seems to support the notion that the downturn is temporary. During those three months, stocks gained nearly 20%—and almost in a straight line. It's certainly not unusual that markets would calm a bit and even retreat after such a strong rally.

At least some of the recent volatility can be attributed to signs of economic headwinds. Reports on unemployment released in late March and late April both were disappointing after three months of strong numbers. The April news that only 115,000 jobs had been created in March fell significantly short of the 160,000 that economists had predicted. Yet when you look beyond the headlines, the latest jobs reports seem a little better. It turns out that there was a net gain of 275,000 positions in January, up from the 243,000 that first was reported, and the figure for February was revised upward to 259,000 from 249,000. Even the disappointing March data, showing only 115,000 new jobs, got bumped up to 154,000, much nearer the original estimate of 160,000. These latest numbers suggest that employment growth at the beginning of the year was stronger than originally thought, and the slowing since then may not have been as pronounced as it first appeared. Moreover, although federal, state, and local governments have continued to pare their work forces, the private sector has kept adding new jobs, and workers in nongovernment jobs also have seen their wages rise. With gasoline prices starting to ebb, consumers are likely to have more money in their pockets—potentially good news for an economy in which consumer spending is responsible for 70% of growth in gross domestic product (GDP).

But for now, underwhelming expansion in U.S. GDP is adding to unease in equity markets. The first government reading of GDP growth in the first quarter was 2.2%, down from 3% during the final quarter of 2011. But this latest bit of data, too, will be subject to revision as statisticians gather more information, and there's a reasonable chance it could fall. One narrower economic indicator, wholesale inventories, came in approximately $2 billion lower than expected in May, and these latest numbers have led some analysts to predict that GDP growth for the first quarter could drop to 1.9% in the next government release, due at the end of May. That, too, likely would weigh on financial markets.

If growth seems to flag again, would the Federal Reserve take steps to bolster the economy? Among the Fed's moves since the global financial crisis exploded in 2008 have been two programs of "quantitative easing," with the U.S. central bank first buying mortgage-backed securities and then Treasury bonds. It followed up more recently with "Operation Twist," in which the Fed sold short-term securities and used the proceeds to buy longer-term bonds. With the economy seeming more secure at the beginning of this year, it appeared that the Fed would hold back on additional stimulus, and its statement after the April meeting of the Federal Open Market Committee (FOMC) gave no indication that there would be additional easing.

The Fed's previous actions helped fuel stock rallies, and the lack of new support may have discouraged some investors. Yet it's clear that if the economy truly stumbles, the central bank will step in again—and that the absence of further moves indicates that chairman Ben Bernanke and his fellow Fed governors believe conditions are improving. Ultimately, investors should take that as positive news. A rise in bond yields also would signal further economic healing. Meanwhile, the fact that analysts keep revising their estimates for corporate earnings upward suggests that business activity is on the upswing and that the markets soon could rebound.

Investors are considering what independent economist Fritz Meyer calls a fiscal cliff: In the face of a ballooning federal deficit, Congress must decide whether to extend current tax laws yet again or let them expire, as scheduled, at the end of the year. If legislators do nothing, tax rates will rise sharply in 2013, and though that could help reduce the budget shortfall it also could restrain economic growth. Most observers expect no action from Congress until after the fall election, and uncertainty about what will happen probably contributed to the recent market slump. Yet while such questions and others could keep things volatile for a bit longer, the overall outlook is largely positive, suggesting that the year's strong early stock rally eventually will resume. ●

bought 10 years ago for $10,000 that is now worth $25,000. If you sell the stock in 2012 and have no other capital gains or losses during the year, you'll pay tax of $2,250 (15% of your $15,000 profit). But if you wait until next year to sell at the same $25,000 price, you'll owe tax of $3,000 (20% of the $15,000 profit). That's an extra $750 in tax you could avoid.

Tax planning that involves investing decisions can quickly become complicated, and it's always important not to let the "tax tail wag the investment dog"—that is, to put tax considerations before sound investment strategies. That's why this year, in particular, it's wise to start considering the possibilities long before year-end deadlines and to consult with your tax and investment advisors. We can help you stay on top of possible changes to the tax laws and work with you to make choices that are right for your situation. ●

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Four Smart Ways To Gift This Year

No one knows for sure what *will* happen to estate and gift tax laws at the end of 2012, but it's crystal clear what *could* occur. Unless Congress acts, the current $5.12-million exemption for estate and gift taxes will drop to $1 million, making it much more expensive to transfer large amounts to your heirs. With that immense change looming, you may want to take action now.

One possibility is to establish an irrevocable trust. You transfer assets to a trust for designated beneficiaries, such as your children, and the high current exemption amount means you're unlikely to face dire estate or gift tax ramifications. But "irrevocable" means just that—you can't get your money back later if you have a squabble with your kids or they make bad lifestyle choices.

Depending on your situation, one of these four alternatives could play a role in your estate plan while helping you take advantage of this year's generous rules.

1. Self-settled trusts. Here you essentially give assets away now, using the high current exemption, but you retain the right to get at the money if you need it. Self-settled trusts are available in just a handful of states, but non-residents can transfer assets to a trustee in one of those states. The trustee decides whether an eligible beneficiary can receive a requested distribution, and assets are generally off-limits to your creditors. But the laws in this area are still evolving.

2. Trust protectors. You also might establish a trust now but design it to have a third-party protector—such as an experienced relative—who oversees the professional trustee and can remove a beneficiary, veto distributions, amend trust terms, or shift the trust to another state. You also can form committees to make key decisions.

3. Grantor trusts. Make sure that any trust you create in 2012 is designated as a grantor trust. As grantor, you'll pay any tax on annual trust income, and those payments won't be treated as gifts now or in future years, when gift tax rules may be more onerous. One sophisticated version is the "intentionally defective irrevocable trust" (IDIT), purposely designed to be treated as a grantor trust while freezing the value of assets for estate tax purposes.

4. Spousal beneficiaries. A simpler way to keep access to money while taking advantage of current tax rules is to create a traditional trust and designate your spouse as a "discretionary beneficiary." The trust can be structured to allow occasional distributions to your spouse, who could establish a separate trust for you. But you'll have to do this carefully so the trusts won't be considered reciprocal.

Bear in mind that this is only a brief overview of four gift tax ideas. Obtain more details for your situation. ●

"Hidden" Tax Break

(Continued from page 1)

shares of the corporation's stock. The shares, originally valued at $5 each, now sell for $50 and your total holdings are worth $1 million.

If you sell the stock within your account and take a cash distribution this year, you will receive $1 million. However, the entire distribution will be taxed at ordinary income rates. If you're in the 35% tax bracket in 2012, you'll be hit with a federal income tax bill of $350,000 (35% of $1 million). On the hand, if you take the distribution in the form of company stock, you're taxed only on the original cost of $100,000 (20,000 shares at $5 a share). Voila—your federal income tax bill is reduced to just $35,000!

Now, let's assume you sell the stock immediately at $50 a share for a total of $1 million. Your $900,000 profit will be taxed as a long-term capital gain at the maximum 15% tax rate in 2012. Therefore, you'll pay $135,000 in tax (15% of $900,000). Your total federal income tax bill will be $170,000 ($35,000 + $135,000)—a tax savings of $180,000 over what would have happened if you'd sold the stock inside the plan and taken a cash distribution. Even if you sell the stock later and capital gain rates are higher, you're still likely to realize substantial tax savings.

Note that Congress has put this giant tax loophole on the cutting block in the past, but so far the tax break has managed to escape the ax. Don't be shocked if new proposals surface as lawmakers again look to drum up tax revenue. Practically speaking, if you can benefit from a plan distribution of company stock now, it could make sense to take advantage of the current rules.

Alternatively, you could sell the stock inside your 401(k) and roll over a cash distribution into an IRA. That would enable you to spread out tax on distributions as you gradually take them, though the withdrawals would be taxed at ordinary income rates. ●

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