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7 Major Tax Changes In The Fiscal Cliff Law

From the edge of the "fiscal cliff," Congress took a step back and approved the American Taxpayer Relief Act (ATRA), a hodgepodge of tax extensions and modifications. But the agreement postponed decisions on spending cuts and failed to continue a 2% "payroll tax holiday" for employees. Moreover, upper-income taxpayers will have to shoulder a greater burden going forward. Here are seven noteworthy changes for individuals.

1. Individual Tax Rates. Across-the-board the board tax hikes are averted and the "marriage penalty" is eased. Nevertheless, ATRA creates an "extra" top tax rate of 39.6% for single filers with income above $400,000 and joint filers with income above $450,000. When you add in the new 3.8% Medicare surtax for certain upper-income investors, which begins in 2013, your effective top tax rate can reach 43.4%!

2. Capital Gains And Dividends. The "Bush tax cuts" for capital gains and dividends are generally preserved. The maximum tax rate remains 15% for net long-term capital gain and qualified dividends (0% for investors in the lowest tax bracket). Otherwise, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket). Even worse, dividends would have been taxed at ordinary income rates. But the upper crust still pays a steep price: a maximum 20% tax applies to single-filers with income above $400,000 and joint-filers with income of more than $450,000.

3. Alternative Minimum Tax. The onerous alternative minimum tax (AMT), which has steadily been casting a wider net each year, is overhauled. Under ATRA, exemption amounts have been increased and nonrefundable personal credits can be used to offset AMT liability in full. In addition, the exemption amounts will be indexed for inflation in the future. Because the changes are retroactive to the 2012 tax year, it's been estimated they will save as many as 60 million taxpayers from the clutches of the AMT.

4. Itemized Deductions And Personal Exemptions. Two other "back-door" tax increases may affect taxes of wealthier individuals. Due to the revival of the "Pease rule," most itemized deductions are reduced by 3% of the amount of adjusted gross income (AGI) above a specified threshold, beginning in 2013 (but the overall reduction can't exceed 80%). At least ATRA establishes higher thresholds of $250,000 for single-filers and $300,000 for joint-filers. A comparable provision begins to phase out the tax benefits of personal exemptions at the same thresholds.

5. Education Tax Breaks. ATRA generally extends several valuable tax incentives relating to higher education. Significantly, it allows parents to claim the maximum $2,500 American Opportunity Tax Credit (AOTC) for another five years, subject to a phaseout based on modified adjusted gross income (MAGI). It also extends the above-the-line deduction for tuition and fees, also phased out based on MAGI, through 2013. This deduction may be claimed in lieu of a higher education credit. The

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Wealthy Boomers Are Less Likely To Leave Inheritance

Compared with their parents' generation, far fewer wealthy baby boomers plan to leave their children a significant inheritance, according to a new study by U.S. Trust. As you approach retirement, you'll need to think about this issue. Is it more important to you to preserve family wealth, or to contribute to societal causes?

Forty-five percent of wealthy baby boomers don't think it's important to leave an inheritance, and one in three said they plan to leave money to charity rather than to their children, according to the 2012 *U.S. Trust Insights on Wealth and Worth* report. Many respondents said they fear their children will lose their work ethic if they expect to inherit money. By contrast, 73% of those over the age of 67 said it's important to leave an inheritance to their children.

One in four boomers said they intend to enjoy their wealth themselves, while other boomers said they plan to leave their children modest amounts or help with their finances while they are young adults.

Yet most young people (ages 18 to 46) of wealthy families may be expecting an inheritance, given that more than three out of four in this group consider it important to leave an inheritance.

Have you thought about these issues? Passing down family wealth is complex, involving personal feelings and family dynamics. We can help you sort through the issues and make solid decisions.

Mary Jane Callaghan & Mitch Glicksman

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Avoid These 7 Investment Mistakes

One thing that can be puzzling about stock market investors who have struggled in the past: They make some of the same mistakes over and over. Here are seven prime examples.

1. You try to "time" the stock market. Typically, timing strategies are based on selling stocks when you believe the market has topped out and buying when you think it has hit rock bottom. The problem is that nobody—and we mean NOBODY—has a crystal ball that's foolproof. It's far better to stick with a well-diversified, balanced portfolio based on your personal circumstances.

2. You have zero patience. If you're looking for instant gratification, the stock market will disappoint you more often than not. Just as for the tortoise and the hare, slow and steady usually wins the race, while those who act too swiftly finish behind. Be content to hold some stocks for a long time before you reap rewards.

3. You refuse to recognize reality. All too often, investors operate with blinders on, but the cold hard facts can't be ignored. If you have a favorite stock you were convinced would turn a profit and it simply hasn't worked out, don't throw good money after bad. Dump the losers and hold on to the winners without allowing emotion to rule the day.

4. You put all of your eggs into one basket. No matter what the projections are for any particular stock, sector or asset type, it's not smart to bet your entire wealth on its performance. Diversification is a key element of a sensible plan for virtually every investor. It's all about balancing the search for reward with the need to reduce risk. Although there's less chance you'll make a killing if you diversify, you reduce your exposure to a catastrophe.

5. You overemphasize past performance. It may be boilerplate language in investment prospectuses and related materials, but it's also true: "Past performance is not necessarily indicative of future results." Don't build your portfolio around particular stocks just because they've been profitable without evaluating their current and future prospects.

6. You ignore the impact of taxes. It only makes sense to consider the tax ramifications of your investment decisions—especially now, with investment and income tax rates set to rise in 2013 and the arrival of a new 3.8% Medicare surtax for high-income investors. But it also can be a mistake to let taxes drive your decisions. Weigh all of the relevant economic factors when you buy or sell stocks.

7. You don't have a plan. Many investors take a hit-or-miss approach to their portfolio. They buy and sell on whims without coordinating their activities. But you're more likely to be successful if you develop an overall plan that is suitable for your situation. Having a strategy and having the discipline to stick with it is the hallmark of successful investing. We would be glad to provide whatever assistance you need. ●

Take A Closer Look At Your RMDs

The IRS allows you to build up a sizeable nest egg for retirement inside your traditional IRAs. But then the other shoe drops: Whether you want to or not, you must begin taking "required minimum distributions" (RMDs) once you reach a certain age. Otherwise, you could be socked with a hefty tax penalty.

But the tax law does provide some flexibility. Depending on your situation, you might decide to withdraw funds from one of your IRAs, all of your IRAs, or any combination you prefer.

You have to start taking RMDs from your IRAs by April 1st of the year after the year in which you turn age 70½. In other words, if your 70th birthday was on June 1, 2012, you must take an RMD for the 2012 tax year by April 1, 2013. Then you still have to take another RMD for the 2013 tax year by December 31, 2013.

The amount of the RMD is based on the value in your accounts on December 31st of the tax year and is calculated according to IRS-approved life expectancy tables. For example, if you have a total balance of $1 million in your IRAs and your age is 76, the distribution period under the life expectancy table is 22 years. Divide $1 million by 22, and you arrive at an RMD of $45,454.55 for the current tax year.

The penalty for failing to take a timely RMD is equal to 50% of the required amount of the distribution (minus any distribution you actually received). Going back to our example, suppose you've taken an RMD for 2012 of $20,454.55, or $25,000 less than the required amount. In this case, you would owe a penalty of $12,500 (50% of $25,000) on top of the regular income tax. If you're in the 35% tax bracket in 2012, that's a whopping total of $28,409 ($15,909 + $12,500)!

Comparable rules apply to tax-deferred earnings within a tax-qualified

Taxes To Rise, Boosting Life Insurance

With high income individuals facing an onslaught of new taxes, life insurance products are likely to become more appealing because of their tax-advantages.

The top federal tax rate of 35% rises to 39.6% in 2013. Also, the top tax rate of 15% on long-term capital gains will rise to 20%. In addition, qualified dividends, which, in 2012 are taxed at a 15% rate, will be treated as ordinary income starting in 2013, so most investors will pay twice as much or more in taxes on dividends. On top of that, millions of high-income taxpayers will face a new 3.8% Medicare surtax on investment income.

One of the few remaining havens from taxation will be life insurance, which remains immune to the latest tax hikes. Indeed, life insurance provides protection from federal estate taxes as well as federal income taxes. So here's a primer on life insurance.

Forms of life insurance. Although there are many variations, life insurance comes two basic forms: permanent and term insurance.

Permanent life insurance, also called "cash value" insurance, stays in force for your entire life as long as you pay required premiums. These policies offer a death benefit but also build up an investment account with a cash value. Typically, you can borrow against the cash value or surrender the policy during your lifetime to tap the accumulated cash value. The amount you receive is the accumulated cash value minus any applicable surrender charges or fees.

Term insurance is also called "pure insurance" because it provides only a death benefit and no cash value or investment account. This is the most economical way to purchase life insurance and protect loved ones. As the name suggests, term insurance covers you for a specific number of years. You might limit coverage to the years during which you're working, when the loss of your income would be a hardship for your family. Once the term expires, so does the policy, unless you elect to renew it at a higher premium. Due to its temporary nature, term insurance is generally less expensive than permanent insurance for a comparable amount of coverage.

Income-tax advantages. A key benefit of permanent life insurance is that the accumulated cash value is generally exempt from income tax. Also, your beneficiaries won't be taxed on the death benefits paid by the policy. Thus, there is no tax when you acquire a policy, no tax as the policy builds up cash value, and no tax when the proceeds are paid to your beneficiaries. That's a tax trifecta.

Estate tax breaks for life insurance are complicated. If you own a life insurance policy as the insured party, the death benefit will be included in your taxable estate when you die, unless the money goes to your surviving spouse (who generally won't be taxed on an inheritance from you). When death benefits go directly to a beneficiary other than to a surviving spouse—such as a child, sibling, or your estate—the proceeds are subject to federal estate tax.

For this purpose, you're considered to be the owner of the policy if you possess any "incidents of ownership." It doesn't take much to trigger this rule. For instance, you're treated as having incidents of ownership if you retain the power to change policy beneficiaries, change coverage amounts, or cancel the policy. In other words, if you name someone other than your spouse as the beneficiary of a life insurance policy—or if your spouse dies before you and the funds go to a contingent beneficiary—your estate might have to pay a hefty estate tax bill.

Fortunately, you can avoid this adverse tax result by establishing an irrevocable life insurance trust (ILIT). If you name the trust as the owner of your life policy, the ILIT pays the premiums and the death benefit ultimately goes to whomever you name as the beneficiary. With this technique, you avoid any incidents of ownership, so there are no dire income or estate tax consequences associated with the life insurance protection.

We proactively look for opportunities to help clients reduce their taxes by using life insurance, and we welcome any questions about this topic. ●

retirement plan such as a 401(k). But you may postpone RMDs from qualified plans (not IRAs) if you continue working past age 70½ as long as you don't own more than 5% of the company that employs you.

The amount of your annual RMD reflects the value of all your IRAs, but you can actually withdraw the funds from one or more of the IRAs. If you're maintaining separate IRAs with different beneficiaries, you might want to keep the balances in all of them equal—and they may have gotten out of whack because of withdrawals, contributions, fees, and investment performance. So, for instance, if you have three IRAs and you've designated a different beneficiary for each one, you could withdraw the entire RMD amount from the IRA with the highest balance. Or you could get rid of underperforming assets in one of your accounts by liquidating those to provide cash for the RMD.

Keep in mind that you must give explicit instructions about your RMDs to each IRA custodian, and please call us if you have any questions. ●

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Which Funds To Tap In Retirement?

Unless you're independently wealthy, eventually you'll have to start using some of the money you've saved for retirement. After all, that's what it's there for, so there's nothing wrong with using those assets. But it could create problems if you spend the "wrong" funds first.

For purposes of deciding what to spend when, let's divide your retirement assets into three baskets: personal accounts, such as stock and bond holdings that are currently taxable; traditional IRAs and qualified retirement plans, such as a 401(k), income from which is typically taxed only when withdrawn during retirement; and non-taxable accounts, such as Roth IRAs.

The rule of thumb is to withdraw funds from your personal accounts first, your traditional IRAs and qualified plans second, and your Roth IRAs third. This spending order is likely to produce the lowest possible tax bill, promote more tax-deferred growth, and allow you to milk your assets for as long as possible. If you were to spend your money in the reverse order, you would pay more in taxes each year, thereby siphoning off funds that could have been reinvested and reducing your overall nest egg—and maybe even exhausting all your funds during your lifetime.

The preferred "spending order" in retirement is only reinforced by tax law changes scheduled to take effect in 2013. Barring last-ditch legislation, the tax brackets for individuals will be adjusted upward, with the current top tax rate of 35% being replaced by 39.6%. Furthermore, the maximum capital gains rate of 15% for most investors (0% for low-income investors) is increasing to 20% (10% for low-income investors). And qualified dividends, currently taxed at a rate no higher than 15%, will be taxable at ordinary income rates.

To add insult to injury for high-income investors, a new 3.8% Medicare surtax debuts in 2013. Under a special tax law provision, an investor must pay the 3.8% surtax on the lesser of "net investment income" or the amount by which modified adjusted gross income (MAGI) exceeds a threshold of $200,000 for single filers or $250,000 for joint filers. "Net investment income" includes most forms of taxable income, such as capital gains and dividends, but not distributions from qualified retirement plans and IRAs or tax-exempt income. Still, those items may increase your MAGI for this calculation.

Despite these tax-based incentives, remember that you generally have to begin taking "required minimum distributions" (RMDs) from qualified retirement plans and IRAs—but not from Roth IRAs—after age 70½. If you've reached that point, you may as well take the RMD amounts first before the regular sequence.

Last but not least: Everyone is different, so you may have valid reasons for changing the usual order. If you have any questions about your situation, please let us know. ●

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tuition deduction extension is retroactive to 2012. Finally, ATRA permanently extends enhancements for Coverdell Education Savings Accounts (CESAs), the tax exclusion for employer-provided education assistance and the student loan interest deduction.

6. Extensions Of Other Rules. Besides those already mentioned, ATRA extends a host of other tax provisions for individuals, many of them retroactive to the beginning of 2012 (i.e., for provisions that technically expired). Most of the extended tax breaks are limited by dollar amounts. The list includes:

- Optional state sales income tax deduction
- Enhanced child tax credit, dependent care credit and adoption credit (and tax exclusion for adoption program assistance)
- Credit for energy-saving at home
- Monthly tax exclusion for certain commuting benefits
- Deduction for mortgage interest premiums
- Deduction for classroom expenses of educators
- Tax exclusion for mortgage debt forgiveness
- Tax benefits for donating real estate for conservation purposes
- Tax-free distributions of IRA funds to charity by those age 70 ½ or over

7. Estate And Gift Taxes. At long last, there's greater certainty in estate planning. Beginning in 2013, the unified estate and gift tax system permanently retains a $5 million exemption and will be indexed annually for inflation, instead of plummeting from $5.12 million in 2012 to $1 million. The top estate tax rate, which was scheduled to jump from 35% in 2012 to 55% in 2013, is bumped up to 40%. ATRA also retains the provision allowing "portability" of estate tax exemptions between spouses and coordinates various other aspects, including implementation of the generation-skipping tax.

These are just some of the highlights of the fiscal cliff law. We will be offering further guidance on the tax law changes, but please don't hesitate to call us about how the changes affect you personally. ●

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