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Guide...Protect...Preserve

New Law Poses Tax Risks For High-Income Investors

It will take time for investors to absorb exactly what happened—and what did *not* happen—in the new tax law enacted to avert the "fiscal cliff." Under the new law, called the American Taxpayer Relief Act (ATRA), favorable tax rates on different types of investment income generally were preserved, but certain upper-income investors will face tax increases, beginning in 2013.

When you combine the ATRA changes with the new 3.8% Medicare surtax—also making its debut in 2013—you could be hit with a rate as high as 43.4% on a portion of your investment income.

Consider the following three main new tax law provisions:

1. Ordinary income. The existing federal income tax rate structure—with rates of 10%, 15%, 25%, 28%, 33%, and 35%—continues for most taxpayers. But ATRA adds a new top tax of 39.6% for single filers with income of more than $400,000 and joint filers with income above $450,000. That means that a short-term capital gain on the sale of a stock you've owned for a year or less—a profit taxed at ordinary income rates—could trigger the 39.6% federal rate.

2. Capital gains and qualified dividends. Under ATRA, the maximum tax rate for net long-term capital gains and qualified dividends remains 15% (0% for investors in the lowest tax bracket). If the law hadn't passed, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket), and dividends were scheduled to be taxed at ordinary income rates. Despite the reprieve for most investors, however, those who exceed those same high-income thresholds—$400,000 for single filers and $450,000 for joint filers—now will pay a maximum 20% tax rate on long-term capital gains and qualified dividends.

3. Medicare surtax. This "add-on" tax actually was included in the 2010 health care legislation—the Patient Protection and Affordable Care Act—rather than ATRA. But it also takes effect in 2013, and it can be just as lethal to upper-income investors as some ATRA changes. A 3.8% Medicare surtax now will apply to the lesser of "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount—$200,000 for single filers and $250,000 for joint filers. These figures will not be indexed for inflation.

For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. Certain items are excluded from the NII definition, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans and IRAs.

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Many Women Face Special Challenges As Retirement Nears

Women often find themselves at a disadvantage when it comes to providing for their retirement years. Data shows women tend to live longer than men do, to earn and save less, to bear the financial brunt of divorce and widowhood, and to spend more time and money taking care of family members.

Life expectancy is increasing for both men and women. But women outlive men by an average of five years, according to the Centers for Disease Control and Prevention. Once a U.S. woman reaches age 65 she is likely to live to the age of 85. That makes women far more likely to outlive their assets.

Advocates debate the reasons behind income disparity, but the fact is that women earn 77 cents for every dollar men earn, according to the U.S. Census Bureau. That means women have fewer dollars to put toward retirement savings, and earn less in Social Security benefits.

Historically, women save less money than men. They usually make less, first of all, and thus are more likely to depend on their spouse's earnings for savings. Women also spend more time and money helping ill family members than do men.

For all of these reasons, losing a spouse, whether through divorce or death, can have a more drastic impact for a woman than a man.

The message is clear: Retirement planning is a vital necessity for women. We recognize the challenges you may face, and we can help you overcome them.

Mary Jane Callaghan & Mitch Glicksman

Find Extra Benefits In DI Insurance

The odds that you'll suffer a disabling injury or illness are far greater than the likelihood of you dying prematurely. A disability income (DI) insurance policy, used to supplement life insurance coverage, could help protect you from loss of income if you're unable to work. Indeed, a DI insurance policy might provide even more benefits than you expect.

Typically, a private DI insurance policy can pick up some of the slack if you're disabled for an extended time. Should you no longer be able to work, you will begin receiving a monthly disability benefit. Normally, the benefit is a predetermined amount, unlike employer-provided coverage, in which the benefit equals a percentage of compensation.

As with life insurance, DI terms can vary widely from policy to policy. Some key variables include the amount of the benefits you'll receive; the length of the coverage; the requirements for receiving full benefits; the definition of "disability"; the length of the waiting period before benefits begin; any cost-of-living adjustments; availability of partial benefits; and possible non-cancellation features. Naturally, the cost of the premiums also will vary, depending mainly on those variables.

But don't assume that you must be bedridden to collect any benefits. Frequently, a DI insurance policy will provide "residual benefits" in the event you can work some of the time or if you're slowly getting back on your feet. Some policies even offer benefits after you've returned to work if you are earning less than you did before your disability.

The residual benefits generally kick in when the loss of income is greater than 20% of previous earnings and the decline is due to the medical condition underlying the disability. This feature could be especially valuable to small business owners, including self-employed entrepreneurs, and professionals in fee-based practices, such as physicians, attorneys, and accountants.

For example, suppose a surgeon recovering from a severe illness returned to practice but was able to see fewer patients. If the surgeon's income was reduced from $50,000 a month to $30,000, the residual benefit could restore income to 80% of the pre-disability level—in this case, $40,000 a month. Similarly, if the side effects of chemotherapy make it too hard for a litigator to appear in court or for a CPA to handle a company's books, the residual benefits can soften the economic blow.

To see what your coverage may or may not include, take a close look at existing DI policies or any new policy you're considering and have your insurance agent explain the residual benefits section. The policy might be more valuable than you imagined or the residual benefits may be too restrictive. Those provisions could be a key component of your DI insurance coverage. ●

Straight Talk About Living Trusts

Ask two financial experts about the benefits of using a revocable living trust and you might well get precisely opposite reactions, especially on a regional basis. One might say that it's the greatest thing since sliced bread, while the other could argue that it should be avoided like the plague. The truth probably lies somewhere in between.

How does a living trust work? You set up the trust, transfer assets to it, and name a trustee to handle matters. If you designate yourself as the "initial beneficiary," you're entitled to receive income from the trust for the rest of your life. At the same time, you designate "secondary beneficiaries"—perhaps your spouse, your children, or both spouse and kids—who will receive the remaining assets when the trust terminates.

Significantly, you can still retain some control of assets in a living trust while you're alive. For instance, depending on the trust terms, you may be able to sell assets and keep the proceeds, amend terms of the trust (for example, change secondary beneficiaries), or revoke it entirely. The assets in the trust become irrevocable upon your death.

The main advantage is that assets in a living trust are exempt from probate, a process that may be required for assets bequeathed through a will. Proponents of living trusts note that the probate process can be costly and time-consuming. Also, if you face physical or mental limitations in your old age, with a living trust, a trustee for your assets is already in place.

However, detractors point out there are less expensive ways of avoiding probate, such as acquiring property jointly with rights of survivorship (although this may not be the best option in community property states). Also, the cost and complexity of probate is often exaggerated and can vary greatly from state to state. Finally, despite a common perception to the contrary, there's no estate tax advantage to using a living

Two More Key Choices For Retirement Living

Choosing a town to live in after you retire and deciding whether you want to be completely independent or to live in a retirement community are both crucial parts of planning for your life after work. But there are also other factors to weigh, and two of the most important may be the proximity of medical care and how far you'll be from your children, grandchildren, and other members of your family.

Aging almost inevitably brings a need for more medical care, and having top-quality physicians and hospitals nearby could help you enjoy a longer and healthier retirement. Some retirement communities and private retirement locations—such as a single-family home in a small town—may be exactly what you're looking for in other regards but aren't located near specialized medical care. A retiree with heart disease, for instance, is likely to want quick access to a cardiologist and a hospital capable of performing angioplasty or open-heart surgery.

It may cost less to live in a remotely located retirement village than in a city that gives you access to top medical facilities. But having lower living expenses will be little consolation if you're not able to get the care you need.

Consider the case of a Florida couple who decided to retire to the mountains of northern Arkansas—where it's beautiful, remote, serene, and inexpensive to live. They purchased a two-story, 2,000-square-foot home built into the side of an Ozark Mountains foothill for $68,500 in late 2004. The nearest hospital, not to mention the nearest cardiologist, is an hour's drive away, however. And the closest hospital may not be the best hospital.

The two retirees had a second hospital choice that had a better-trained, more qualified staff, better equipment, and a greater ability to handle trauma and heart attack victims in the emergency room. That second hospital is almost an hour and a half drive away from their home, however.

The husband suffered a heart attack in 2006 and was taken to the closer of the two hospitals. He received a stent, recovered, and is alive and well today. He knows, however, that he was lucky, and the incident played a role in the couple's decision to leave their beautiful mountain abode, located in the middle of a hardwood forest, and move back to Florida, close to top-notch doctors and health-care facilities.

The other factor in their decision to move back to Florida was the distance from their family. Together they have seven sons, a daughter, 13 grandchildren, and seven great-grandchildren—and all but three of them live in Florida. It was a two-day drive from northern Arkansas to the Tampa Bay area of Florida, where the couple had lived before they relocated and where two of their sons still live.

They were jolted into reality when one son was divorced in 2008 and was awarded joint custody of his two children. That was a development the parents hadn't anticipated when planning their retirement. It also was something that would change their lives, again.

To add to the urgency of the situation, the son now was working six days a week and needed someone to care for his children on the days that he had custody. His mother was the most logical choice, but she now lived in Arkansas.

Hence, the couple decided to move back to the Tampa Bay area, not only to be near the divorced son but also so they'd have a good team of cardiologists and one of the best heart hospitals in the region close at hand. Finding a suitable retirement home set off a frantic search that ended rather quickly when the couple bought a duplex in an over-55 community.

Selling their home in Arkansas didn't go quite so smoothly, however. They had bought their mountain hideaway when real estate prices were still rising steeply, and by the time they were ready to sell, the local market was slumping. They were fortunate that their retirement home had not cost that much in the first place. By being patient, and not accepting low-ball offers, they were able to recoup their investment in the house a year after they'd offered it for sale. Meanwhile, they'd done well at the other end of their relocation, selling their first Florida home in 2004, near the top of the boom, and returning in 2008, when home prices were plunging.

Your situation won't be exactly like theirs, of course. But you could well face some of the same considerations in choosing where to spend your retirement. Having access to good health care and being able to reach out and touch your loved ones are very important, especially as you grow older. ●

trust if you retain the right to revoke it, as is typically provided. And even die-hard supporters of living trusts acknowledge you'll still need a will to tie up the loose ends of your estate.

So when does a living trust make sense? Consider these four key factors:

1. Age. Younger people in good health have less incentive to use a living trust than do retirees. Remember, a living trust will provide little benefit during your life.

2. Financial status. The more wealth you have, the more you're likely to benefit from a living trust. It will make things easier on your heirs if some or all of your assets bypass probate.

3. Marital status. If you're married and you own a house or other main assets jointly with your spouse, there's less need for a living trust. Furthermore, many states allow surviving spouses to use expedited probate procedures.

4. Confidentiality. One of the main arguments for a living trust is that your testamentary disposition remains confidential. This could be important for some families.

Don't be swayed by the hype of either point of view. Make an assessment of whether a living trust is right for you. ●

Which Type Of IRA Do You Prefer?

There are two basic types of IRAs for retirement savers: the traditional IRA that has been around for decades and the Roth IRA, a more recent innovation. Each has pros and cons, so the choice often depends on your circumstances. To help you decide, here's a brief comparison.

First, be aware that both IRAs share some common traits. The contribution limit for 2013 for all IRAs (of either type) is $5,500 (up from $5,000 in 2012). If you're age 50 or older, you can kick in an extra $1,000. There's no current tax on earnings from contributions within either IRA. And the deadline for contributions is the tax return due date for the year of the contribution, with no extensions permitted.

Now let's examine the key differences.

1. Traditional IRAs. If your modified adjusted gross income (MAGI) exceeds a specified annual level and you actively participate in an employer retirement plan, the deductibility of your contributions will be phased out. The phaseout for 2013 occurs for a MAGI between $59,000 and $69,000 for single filers, and between $95,000 and $115,000 for joint filers. If your spouse participates in an employer plan but you don't, the phase-out range is between $178,000 and $188,000 of MAGI. Thus, many high-income individuals can't deduct any part of their contributions.

When you take distributions during retirement, you're taxed at ordinary income rates on the portion representing deductible contributions and earnings. Furthermore, if you're under age 59½ when you take a distribution, you must pay a 10% tax penalty (unless one of several exceptions applies).

2. Roth IRAs. Unlike with a traditional IRA, contributions to a Roth are never deductible, regardless of your MAGI. In addition, the ability to make full contributions to a Roth is phased out for 2013 for a MAGI between $122,000 and $127,000 for single filers, and between $178,000 and $188,000 for joint filers.

However, qualified distributions from a Roth in existence for at least five years are 100% tax-free. This includes distributions made (1) after age 59½, (2) due to death or disability, or (3) used to pay qualified first-time homebuyer expenses (lifetime limit of $10,000). Other distributions are taxed at ordinary income rates under "ordering rules," which treat contributions as coming out first, then conversion and rollover amounts, and finally earnings. So a portion or all of a payout still may be tax-free.

Due to the back-end benefits, you might convert funds in a traditional IRA to a Roth, paying tax in the year of conversion. If it suits your purposes, you can "undo" the conversion by the tax return due date (including any extension).

Which type of IRA is best for you? Figure it out by factoring in all the variables. We can help you crunch the numbers. ●

New Law Poses Tax Risks

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Now let's see how these tax changes might affect taxes on investment income:

Example 1. You're a joint filer with an annual MAGI of $170,000 consisting mainly of wages. This puts you in the regular 28% tax bracket. At the end of the year, you realize short-term capital gains of $10,000 and long-term capital gains of $40,000, for a total of $50,000 in NII. Because you don't exceed the threshold for ordinary income, your short-term gains still are taxed at the 28% rate. And you don't exceed the threshold for capital gains either, so your long-term gains are taxed at the 15% rate. Finally, the lesser of your NII or excess MAGI is zero, so you don't have to pay the 3.8% Medicare surtax.

Example 2. You're a single filer with an annual MAGI of $500,000, consisting mainly of wages. This puts you in the new top tax bracket of 39.6%. At the end of the year, you realize short-term capital gains of $25,000 and long-term capital gains of $75,000, for a total of $100,000 in NII. Your short-term gains are taxed as ordinary income at the 39.6% rate. In addition, you exceed the threshold for capital gains, so your long-term gains are taxed at the 20% rate. Finally, the lesser of your NII or excess MAGI is $100,000, triggering a Medicare surtax of $3,800 on top of your other taxes.

Accordingly, the new tax rules could affect the rates you pay on investment income. And while taxes alone never should determine your investment decisions, it makes sense to factor them in when you're considering what and when to buy or sell. Depending on your situation, you might accelerate income or capital gains into the current year to avoid higher taxes next year, or you could postpone income or gains to next year to avoid higher taxes this year. We can work with your tax advisor to help you decide what makes sense in your situation. ●

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