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Eight Of The Best Tax Strategies To Use In 2012

This is shaping up to be an interesting, and possibly historic, year for tax planning. Scheduled increases in tax rates for 2013 and beyond, the imposition of a new 3.8% surtax on high-income investors, and the upcoming national elections all could have an impact on your tax bill for years to come. But don't wait until the election votes have been tabulated to develop your key strategies for 2012. By then, it may be too late to take any meaningful action. Here are eight tax-smart ideas you can put into play right away.

1. Distribute dividends of C corporations. If you're the owner of a C corporation, it probably will make sense to have dividends paid out to you in 2012. This year, "qualified dividends"—including those paid by most domestic companies—are taxed at a maximum tax rate of only 15%. Unless Congress enacts new legislation, however, beginning in 2013 all dividends will be taxed at ordinary income rates of as high as 39.6%. That could more than double your tax liability for that income.

2. Sell appreciated property. If you own securities or other capital assets that have grown in value, consider selling the property before 2013. The reason is that long-term capital gains—for assets you've held for more than a year—will also be taxed at a maximum rate of 15% in 2012. Absent new legislation, however, the maximum tax rate for long-term capital gains will jump to 20% in 2013. Thus, it could be beneficial to start harvesting gains in anticipation of that change.

3. Accelerate installment sales of property. Similarly, if you're contemplating a future sale of real estate on an installment basis, you might move up the sale to 2012, so that a portion of the gain on the sale will be realized in 2012. If it suits your purposes, you can arrange to recognize a larger portion of a gain from a sale—or even the remaining gain from a prior sale—this year. But keep in mind that if you take this approach you will forfeit any benefit you would have gotten from tax deferral.

4. Sell bonds with accrued interest. If you sell a bond before maturity, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income in the year of the sale. But since ordinary income tax rates are scheduled to rise in 2013—the current top rate of 35% will increase to 39.6% in 2013—you can actually save money by selling in 2012, especially if you're in a high tax bracket.

5. Liquidate underperforming nonqualified annuities. A nonqualified annuity is an annuity that isn't part of a tax-deferred account such as a 401(k) plan, traditional or Roth IRA, or another tax-advantaged retirement plan. Any gain from the sale of a

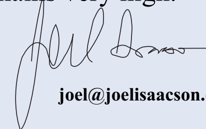
(Continued on page 4)

Encouraging Start To 2012

Stocks and other risk assets surged in the first quarter, continuing the strong run that began in the fourth quarter of last year. In each of the past two quarters, domestic stocks gained about 12%. Developed foreign stocks increased nearly 12% in the quarter, emerging-markets stocks gained 14%, small-cap U.S. stocks were up 12%, and high-yield bonds rose 5%. In contrast, the core investment-grade bond index was flat, as Treasury bond prices declined and yields increased.

Among the drivers of the rally in risk assets are the receding fear of a European financial crisis (at least for the time being), and positive U.S. economic data points, particularly with respect to employment, consumer sentiment and bank stress tests. However, the huge amount of debt in the developed world will continue to drive expectations in the years ahead. All options will involve economic pain compounded by political uncertainty.

As we move through 2012, it will be important to plan for a very significant date: January 1, 2013. This is when the Bush-era tax cuts, the temporary payroll tax cut, and extended unemployment benefits are due to expire, and $1.2 trillion of automatic Federal spending cuts begin to kick in. Additionally, the current $5 million dollar per person estate and gift tax exemptions are set to revert back to $1 million each. It seems unlikely that it will actually play out this way without any modifications, but the risk of political dysfunction, particularly in an election year, remains very high.



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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. ●

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

Invest Safely Based On Interest Rates

Stocks and bonds remain the foundation of a good investment plan. But because of debt problems in the United States and Europe, and a U.S. economy that's recovering slowly despite the stimulus of interest rates that have been near record lows, bonds these days may not seem particularly appealing. Current yields on short-term bonds are negligible, and opting for longer maturities means dealing with the dual risks of inflation and rising rates, both of which can hurt bond prices. Still, last summer's turmoil surrounding the Standard & Poor's downgrade of U.S. debt failed to scare off bond investors, who continued to flock to the investments' relative safety. And in terms of total return—the combination of a bond's price appreciation and interest income—bonds have been one of the best-performing assets in recent months.

Given the lack of certainty about the direction of interest rates and inflation, choosing intermediate- and short-term bond funds—rather than committing to funds that focus on long-term holdings—could be advisable. Accepting lower payouts now on shorter-term bonds could pay off if rates rise, because such bonds would be easier to sell and their prices wouldn't suffer as much as those of long-term bonds.

Until interest rates begin to climb again, as will inevitably happen, your mission is to locate sound investments that will provide a reasonable return without locking in a rate for an inordinate amount of time. Just a few years ago no one would have predicted mortgage interest rates on 30-year fixed loans nearing 4% and 5-year CDs paying substantially less than 2%, but both have happened. If you own a retirement annuity or universal life policy, it may provide a "guaranteed minimum interest rate" that could now make such investments relatively attractive compared with other options.

And what about your portfolio's allocation to stocks? Interest rates come into play here, too, with income-seeking investors, for example, considering dividend-paying companies that may provide attractive payouts without adding high risks. In general, building a relatively safe allocation to stocks may come from increasing diversification or investing in conservative funds with a track record of paying dividends.

In the first case, further diversifying your equity holdings can be a smart investment strategy for now and into the future. That could entail going being beyond diversified equity funds that only invest in U.S. stocks. For greater diversification, consider international and global equity funds that may benefit from higher rates of economic growth in non-U.S. markets.

Another idea for further diversification is to add specialty stock funds to your portfolio. For example, gold funds have been solid investments for several years. But keep in mind that this investment can tarnish quickly, and the general rule of thumb is to put no more than 5% of your investment dollars to work in such funds. Other options for increasing diversification are specialty funds that invest in real estate, natural resources, or basic materials.

Meanwhile, opting for conservative stock funds can be another way to minimize volatility while potentially enhancing portfolio returns. These days, with the economy slowly rebounding, growth funds and those focused on small companies may seem poised to outperform other investments. Yet such holding also bring higher risks, and for now, it may be safer to favor equity-income funds that invest in high-quality, dividend-paying stocks. If the market tanks, they may not drop as far as riskier options, and the dividends can cushion some of the fall.

As you refine your investment plan for now and the future, these strategies take today's interest rates into account in creating a portfolio that may achieve reasonable returns while providing some protection from surprises that could jolt investment markets. By emphasizing increased diversification, you may reduce your overall risk and still grow your portfolio over time. ●

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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. ●

Newly Widowed Face 401(k), IRA Options

Suppose your spouse suddenly died and left you with a multitude of tough financial decisions. One crucial choice would be what to do with the funds in your spouse's 401(k) plans and IRAs. There are several alternatives to consider, once you've had time to collect your thoughts and you feel emotionally prepared to proceed.

One possibility would be to roll the assets in those accounts into your own retirement plans. That's usually permitted, as long as you meet a few requirements, and it would allow the investments from the spouse's plans to continue to grow and compound tax-deferred until you were ready to make withdrawals.

Under the rules for required minimum distributions, or RMDs, you must begin withdrawals after age 70½ (except for qualified plans if you're still working). For inherited accounts, surviving spouses can use their own life expectancy in calculating the RMDs. If you're younger than your spouse, that will result in smaller required withdrawals—and lower taxes—than if the distributions had been based on the spouse's life expectancy.

Another option is electing to treat the accounts as if they still belonged to the deceased spouse. Typically, this is a consideration if the spouse died before age 70½ and the surviving spouse is under age 59½. In that case, the surviving spouse can defer RMDs until the time at which the deceased spouse would have had to begin withdrawals. Then, once the surviving spouse reaches age 59½, the accounts can be rolled over to accounts in that spouse's name, or funds can be withdrawn without paying the 10% penalty.

A third alternative is to use the money in the deceased spouse's 401(k)s and IRAs to fund a "bypass trust" (also known as an AB trust). You could do that if a provision in the deceased spouse's will had established such a trust, or you could "disclaim" the assets that you would otherwise inherit and have the funds go into the trust. You wouldn't owe any income tax on that money until withdrawals begin. In this situation, RMDs are calculated over the life expectancy of the surviving spouse. However, once the retirement accounts become part of the trust, a surviving spouse can't designate the beneficiaries to receive the funds after that spouse's death.

Finally, of course, you could simply take a distribution of all of the assets in your late spouse's retirement accounts. But that's much less desirable from an income tax standpoint. The money from the 401(k)s and IRAs will be taxed at your ordinary income rates in the year you receive the funds. And if the accounts have substantial assets, you'll likely pay tax on a substantial portion of them at the top individual rate of 35%.

Choosing among these options and related strategies can be complicated. We can work with you and your tax advisor to help you make decisions that make sense in your situation. ●

The Best Tax Strategies

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nonqualified annuity is taxed at ordinary income rates. So if you're ready to unload a nonqualified annuity that hasn't met expectations, this is the year to do it, based on the pending tax changes for 2013.

6. Exercise nonqualified stock options. You don't have to pay any tax when your company grants you nonqualified stock options. However, once you exercise the options, you're taxed on the "compensation element"—the difference between the exercise price and the market value in that year. Therefore, if you're holding options on stock that has increased in value, you could decide to exercise the options in 2012 due to the current tax rate structure.

7. Convert a traditional IRA to a Roth. While payouts from traditional IRAs are generally taxed at high ordinary income rates, qualified distributions from a Roth that has been established for at least five years are completely tax-free. The problem is that you have to pay tax at ordinary income rates on the amount you convert. With tax rates rising next year, it could pay to bite the bullet on a 2012 conversion. (If the price of the assets subsequently plummets, leaving you to pay unnecessary tax on their vanished value, you can still "recharacterize" the Roth as a traditional IRA next year and avoid the conversion tax.)

8. Buy permanent life insurance. Although this isn't strictly an income tax strategy, permanent life insurance—including variations of whole life and universal life insurance—is one of the last great tax shelters. Should you die unexpectedly, your heirs will be entitled to the proceeds without any income tax strings attached. And if you've made the proper provisions, the proceeds will also be removed from your taxable estate. ●

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