



## Watch Out For Tax Traps In The Fiscal Cliff Law

**T**here's a lot to like for most taxpayers in the American Taxpayer Relief Act (ATRA), the eleventh-hour legislation that Congress enacted just as we were about to go over the "fiscal cliff." The new law generally preserves favorable income tax rates on investment income, although some upper-income investors now must pay higher rates. And ATRA provides much-needed relief from the alternative minimum tax (AMT) and estate taxes, while extending a slew of other tax breaks, though with a few modifications.

But there's also some bad news tucked away in the 157 pages of the law. In particular, there are two new tax traps that effectively could reduce your tax refund for the 2013 tax year or increase the amount you'll have to pay Uncle Sam. The two potential stumbling blocks are commonly referred to as the "Pease rule" and the "PEP rule" (for "personal exemption phaseout").

**The Pease Rule.** Under the Pease rule (named for the congressman who initially championed this amendment in the 1980s), most itemized deductions are reduced by 3% of the amount that your adjusted gross income (AGI) exceeds a specified dollar threshold, though they can't be cut by more than 80% overall. This provision in the tax law was phased out gradually by the Economic Growth and Tax Relief Reconciliation

Act of 2001 (EGTRRA). However, it was scheduled to return in 2011, before the 2010 Tax Relief Act provided a temporary reprieve through 2012. Now, finally, the Pease rule has been revived permanently.



At least ATRA raises the dollar thresholds from the levels that originally were scheduled for 2013. Previously, the limit would have been \$178,150 for both single and joint filers, based on an inflation

adjustment. Under ATRA, the dollar threshold is \$250,000 for single filers and \$300,000 for joint filers. Make more than that, though, and you could stand to lose a portion of your itemized deductions due to this rule.

**Example:** Suppose you're a joint filer with an AGI of \$400,000 in 2013. That's \$100,000 above the threshold, and so the \$50,000 in itemized deductions that you claimed will be reduced by the Pease rule to \$47,000 – (\$50,000 minus 3% of \$100,000).

Note that the Pease rule applies to many of the deductions that are likely to produce big write-offs, such as charitable donations, mortgage interest, state and local income taxes, and property taxes and miscellaneous expenses. On the other hand, it doesn't apply to deductions for medical expenses, investment interest, or casualty and theft or gambling losses, because those already have their own built-in thresholds.

(Continued on page 4)

## Spring 2013

**F**ueled by continued Fed support and positive signs on the economy, including housing and corporate profitability, U.S. stocks posted their best first quarter since 1998, with the S&P 500 Index gaining 10.6%. Developed foreign stocks were held back by Europe and only posted a 3.8% gain for the quarter. Emerging markets lost 3.5% amidst signs of economic slowing in key countries. Meanwhile, the broad bond-market index was nearly flat.

The U.S. stock market shrugged off government spending cuts (sequestration) without much drama in the first quarter. How and when we deal with the issue of our growing deficit remains a major unknown. What we do know is that these challenges cannot be resolved without spending less and/or taxing more, resulting in an economic headwind. Most experts agree the Fed has no immediate plans to tighten its stimulative policies. However, there is significant uncertainty as to the medium to long term consequences of these policies and whether the Fed's exit plan will be executed successfully. As the economic recovery approaches four years old, it seems to be in a "two steps forward, one step back" pattern. Most indicators point to a similar pattern continuing for the markets as well, with significant cash still on the sidelines, bond markets seemingly offering little upside and equities comparatively attractive. Investors should continue to be prepared for the requisite bumps along the road, whether provided by normal market gyrations, geopolitical events or of the self-inflicted variety, courtesy of our elected officials in Washington, D.C.

# Where Will You Live After You Retire?

**P**lanning your retirement involves far more than determining how much income you'll need. One of the most basic and important decisions is where you want to live during your retirement years.

Choosing a location is something you can start working on early, as much as five to 10 years before you leave work. Don't wait until retirement is just around the corner, because the process of comparing and contrasting different regions can be time-consuming and eye-opening.

The first step is to decide whether you want to remain where you are or move to a new place. It's a very personal starting point, and often it will take into account proximity to family members and attachment to your community.

For those who decide to move on, here are some steps to make sure you end up in a happy place:

- **Discuss your desires.** Do you dream about lying on a beach with the latest bestseller, or reeling in giant marlin from deep water? Do you envision attending symphonies and plays, or riding horses and hiking up mountains? Will you play golf or visit museums and the library? Do you want lots of sunshine or four seasons? Small town or big city? Lots of restaurants

or lots of bait shops? Start by writing down a clear picture of your life in retirement.

- **Do your homework.** Start matching real places with your dream retirement activities and environment. Look into weather, demographics, health care costs and health care availability for hospitals and medical specialties, crime statistics, and other factors using popular "Best Places To Retire" guides. Generate a list of three or four places that look like good matches.
- **Dip your toe in.** Schedule a trip to each area, and make it a long vacation if possible, up to several weeks. Try to visit each area at different times (e.g., when weather isn't ideal) and experience as many things as you can while there. Are the people friendly? Do any unexpected difficulties pop up? Does it match your vision?
- **Consider longer visits.** If your short-term visits leave you



uncertain, consider renting your current home out while you spend even more time in your potential locations. Take several months to get a real feel for the area and make your decision. After all, you

hope to live there for a long time to come!

Once you decide on a location, it's time to look at some financial factors, starting with the sale of your current home. Ask several realtors for an estimate, and compare what you're likely to clear from the sale with what you'll need in your new area. We can help you do

these calculations, and we'll add any expected surplus into your income calculations, and take into account tax and other implications.

Relocating can be one of the most stressful aspects of retirement. Work with a financial advisor who understands all the state and estate tax implications and how moving affects your financial outlook and quality of life. ●

## A Realistic Look At A Hot Topic: Dividend Stocks

**W**all Street pundits are lining up to tout the prospects for dividend-paying stocks in 2013, but prudent investors need to understand the bigger picture before rushing into this hot area of the market.

It's true that dividend-paying stocks made a solid comeback in 2012 and offer good prospects for 2013, but it's important to keep this trend in perspective. The percentage of profits paid out by companies in the form of dividends remains far below historical averages, and an economic downturn could prompt U.S. firms to pull back on dividends again at any time.

As an investor, you also need to

consider dividend stocks relative to other income-producing investments, in the context of a low-interest environment and your own portfolio. Because no one can say for sure which investments will outperform others, it's important to strike a prudent balance among possible choices.

A number of analysts believe dividend-paying stocks will produce solid returns this year for several reasons, starting with the fact that many large companies have built up huge cash reserves as they proceeded cautiously through the wreckage of the 2008 fiscal crisis. "While companies are paying out record dividends, these

amounts are still significantly below historical payout rates," wrote Standard & Poor's analyst Howard Silverblatt in the firm's annual dividend report in January. "It's not a matter of companies being cheap. It's a matter of them being nervous about the economy and their resources, similar to most of us."

Companies in the S&P 500 index paid out a record \$281.5 billion in dividends in 2012, 17% more than in 2011. Yet the payout ratio—the percentage of profits that companies devoted to dividends—was just 36%, far below the historical average of 52%.

# Weigh The Key Factors For A Roth Conversion

**E**ver since the Roth IRA was introduced—way back in 1998—financial planners have been bombarded with questions about this retirement planning tool. Can I covert a traditional IRA to a Roth? If I can, should I? And if it is a good idea, when should I convert?

There's no blanket answer to all of those questions. To a great extent, the decision to convert or not will depend on your particular circumstances. Still, there are several key factors for you to weigh, and general guidelines based on the current tax landscape.

If you have a traditional IRA, all of the distributions you receive (to the extent that they represent deductible contributions and earnings) will be taxed at ordinary income rates. Beginning in 2013, the top tax rate on ordinary income was raised from 35% to 39.6%. In addition, a 3.8% Medicare surtax now applies to the lesser of your "net investment income" (NII) or the amount of your modified adjusted gross income (MAGI) that exceeds \$200,000 for single filers and \$250,000 for joint filers. Although IRA distributions don't count as NII for the surtax calculation, they can still boost your annual MAGI. As a result, you might pay an effective federal income tax rate of 43.4% on all or part of your IRA distributions.

In contrast, qualified distributions

from a Roth IRA that you've had for at least five years are 100% tax-free. For these purposes, "qualified distributions" include those you take after you reach age 59½; because of death or disability; or that are used for first-time homebuyer expenses (up to a lifetime limit of \$10,000). For instance, if you convert a traditional IRA with \$1 million in assets to a Roth IRA at age 55, you can withdraw the entire \$1 million, plus any earnings, at age 60 without paying a dime in additional federal income tax. (You will already have been taxed on the amount you converted to the Roth.)

Another important distinction is that you must begin taking required minimum distributions (RMDs) from a traditional IRA after reaching age 70½; in contrast, there are no mandatory lifetime RMDs with a Roth. This can be a crucial advantage if you won't need IRA funds in retirement.

It used to be that you couldn't convert to a Roth in a year in which your MAGI exceeded \$100,000. But that barrier was removed in 2010, so conversions are now available to all retirement savers.

The main stumbling block is that a conversion is taxable at ordinary income rates just as if you had withdrawn the amount as a regular distribution. That means you need to examine at least four

key factors in the conversion decision.

## 1. The tax rate differential.

Compare your current tax rate with the tax rate bracket you expect to be in when you withdraw funds from your IRA in retirement. The lower your current rate as compared to the expected retirement rate, the greater the incentive to convert now. Conversely, you may not want to convert if your current rate is much higher than your expected rate during retirement.

## 2. Availability of non-IRA funds.

One frequently overlooked Roth conversion question involves whether you have funds on hand to pay a significant conversion tax. If you'll be forced to siphon funds from your IRA to pay the tax bill, you're diluting the future benefit of a conversion. But a conversion now could make sense if you have money in other accounts to cover the resulting tax.

**3. Funds you have to pay living expenses.** Will you need to begin drawing down IRA funds within the next few years? If you have to tap a Roth right away, you may not realize the full benefit of the tax-free distributions. If you can keep your IRA intact for a longer period, a conversion may be more attractive.

**4. Time horizon.** A Roth conversion may appeal most to middle-aged investors who are still several years from retirement. If retirement is imminent or you're already retired, that may reduce your incentive to make a conversion. Nevertheless, switching to a Roth may still be reasonable if you're older, especially if you're looking for ways to preserve assets for your heirs.

Focusing on these four factors, crunch the numbers to see whether a Roth makes sense for your situation. One or more factors may count more heavily for you than others do, and we can help you do a detailed analysis.

Finally: Don't worry about pulling the trigger on a conversion and then regretting your decision. You can "recharacterize" a Roth IRA as a traditional IRA if you make the decision in advance of the tax return due date (plus extensions) for the year of the conversion. ●

That leaves companies with a lot of room to increase dividend payments, according to Silverblatt, who predicted another record for regular cash dividends in 2013. "The 2.8% overall equity yield remains relatively high, even at the higher dividend tax rate (now 20% for certain upper-income investors), when compared to competing income producers such as corporate bonds, Treasuries, or bank CDs," Silverblatt wrote in the report. "Given the range of yields within equities, from lower yielding growth

issues to higher yielding income producers, this leaves investors with one of the few remaining areas of choice with measurable degrees of stability."



Still, the potential for the economy to turn downward dictates continued caution for investors. It doesn't take much of a decrease in stock prices to more than offset whatever income you derive from dividends. In any event, dividend-paying stocks may play a positive role as part of a well-balanced portfolio tailored to your individual goals. ●



# Dust Off Life Insurance Policies

**W**hen was the last time you reviewed your life insurance policies? If you're like most people, you've probably stashed your policies in a drawer, filing cabinet, or safe deposit box where they've been gathering dust. But you should review your policies periodically to see whether they still meet your needs. Depending on the outcome, you might adjust your coverage.

In particular, you should examine your policy if you've experienced one or more major "life events" during the past year. What sort of events are we talking about?

- There may have been a birth, death, or disability in the family.
- You got married, divorced, or separated.
- You bought or sold a principal residence, vacation home, or other real estate property.
- Your child completed college or graduate school.
- You acquired property as a joint tenant.
- You have switched jobs, retired, or started up a new business.
- There was a significant economic

change affecting your business operation.

- You need to revise the beneficiaries of your insurance policies due to a change in circumstances.

Note that other changes that might trigger a life insurance review could be less obvious. For instance, you may need additional coverage if you're now taking on financial

responsibilities for an elderly or disabled relative. Conversely, your financial responsibilities may decrease somewhat if you have finished paying off a home.

Furthermore, you should try to view your family's needs as if you were buying life insurance for the first time. It's your current and future circumstances that are the critical factors—not how things were last year or several years before. And don't forget to review all of your life insurance policies, including any group coverage that your employer (and your spouse's employer) might

be providing.

Needless to say, this is an on-going process. A main function of life insurance is to replace lost income that your family relies on if you should die prematurely. When your financial obligations are small, the amount of life insurance coverage you require is also small. However, as those obligations grow, so does your need to

acquire more coverage.

Typically, your life insurance needs will be at their greatest when your children are relatively young and you're in the midst of your career. Once your children have flown the coop, or you have retired, your insurance needs will likely not be as great.

Best approach: Assess your life insurance needs at regular intervals. You may want to do so at the start of a new year or on some other "anniversary" date. In any event, don't let too much time go by without a regular check-up. ●



## Watch Out For Tax Traps

*(Continued from page 1)*

The PEP Rule. The PEP rule has followed a path similar to that of the Pease rule. It was phased out gradually by EGTRRA before reinstatement of this provision was postponed by the 2010 Tax Relief Act. Now the PEP rule is back with a vengeance for 2013 and thereafter.

This onerous rule reduces the total amount of personal exemptions you may claim—including for yourself, your spouse (if you're married), and your dependents—by 2% for each \$2,500 (or portion thereof) by which your AGI exceeds a specified dollar threshold. Each exemption in 2013 is \$3,900.

Unlike the Pease rule, there's no limit

on the overall amount of the reduction with the PEP rule, so personal exemptions could be phased out completely for some high-income taxpayers.

As with the rule for itemized deductions, however, ATRA raises the applicable thresholds for the PEP rule to \$250,000 for single filers and \$300,000 for joint filers. Without this change, the thresholds for 2013 would have been \$178,150 for single filers and \$267,200 for joint filers. Yet the reduction of exemptions still can be significant.

Example: Suppose you're a joint filer with an AGI of \$400,000 in 2013 and you're entitled to a total of four

personal exemptions. Under the PEP rule, your exemptions are reduced by 2% of each \$2,500 above the limit for

AGI, or a total of 80%—40 (\$100,000 divided by \$2,500) times 2%.

Therefore, your personal exemptions of \$15,600 (\$3,900 times four) are reduced all the way down to \$3,120.

The reinstatement of the Pease and PEP rules could affect tax planning for high-income people. For instance, when appropriate, you might accelerate or postpone certain deductible expenses at the end of the year, depending on your personal circumstances. Make sure you take all of the prevailing rules into account. ●

