

Reap What You Sow: When To Harvest Stock Losses

As the year progresses, thoughts of investors inevitably turn to taxes. Of course, in most cases investment factors will have more to do with the decisions you make than taxes will, but some of your investment moves indeed may be designed to improve your tax situation. After all, how much you pocket after taxes, not how much you earn from securities transactions, counts the most.



It's probably a matter of routine for you to try to "harvest" capital losses, especially as the year winds down, to offset capital gains from stock sales realized earlier in the year. By and large, that still makes sense. But this year, the likelihood that tax rates soon will increase across the board adds another wrinkle that could make it important to fine-tune your tax-related investment strategies.

First, let's look at the basics. For federal income-tax purposes, capital gains and losses are "netted" under the following rules at tax-return time: First, long-term gains and losses are separated from short-term gains and losses. A capital gain or loss is long term if you've held a security for more than one year before you sell it. For example, if you acquired stock on December 1, 2011, and you sell it at a profit on November 30, 2012, your gain is treated as a short term. But if you hold the stock just two days longer—until at least December 2—you qualify for long-term capital-gain treatment.

Then you place all of your long-

term gains and long-term losses in one basket. This gives you either a net long-term gain or a net long-term loss. Next, you place your short-term gains and short-term losses in another basket—

and end up with either a net short-term gain or a net short-term loss.

Finally, you combine the net long-term gain or loss with the net short-term gain or loss to arrive at an overall net capital gain or loss.

If your capital gains exceed your losses, the maximum tax rate on any net long-term gain in 2012 is 15% for someone in a regular tax bracket of 25% or higher (0% for investors in the lower regular tax brackets). Conversely, if your capital losses exceed your gains, the net loss can be used to offset up to \$3,000 of highly taxed ordinary income, such as your salary. If your loss is more than \$3,000, you can carry the excess to future years. (Keep in mind, though, that under the "wash sale rule," you can't deduct a capital loss if you reacquire substantially identical securities within 30 days of a sale.)

Those are the basic ground rules and they haven't changed. However, the usual tax harvesting of capital losses is complicated this year due to three pending tax law changes:

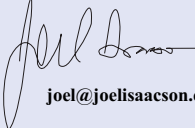
1. The maximum tax rate for net long-term capital gain is scheduled to increase to 20% in 2013 (10% for investors in the lower regular income brackets). Thus, there's a powerful tax incentive to realize capital gains this year.

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Staying Cool When It Is Hot

The second quarter of 2012 closed with a spike in volatility as news out of Europe sparked hope that fiscal and monetary cooperation could keep the fiscal crisis from spinning out of control. However, after factoring in market declines in both April and May (driven by pessimistic news out of Europe), U.S. stocks finished the quarter down almost 3%, while developed market foreign stocks were off 7% and emerging-markets stocks lost more than 8%. On the bond side, the Vanguard Total Bond Market index fund and the Merrill Lynch U.S. High Yield index both gained about 2% for the quarter, the latter earned all of its gain in June as risk assets rallied, while the former earned all its gain in April and May. In each of the last three years, there have been strong market rallies early in the year followed by market corrections ranging from about 9% to 19%. Debt-related fault lines in the global economy have not stabilized, and headwinds will continue to hamper economic growth and create macro risks for the foreseeable future.

Although it is difficult not to get caught up in the emotion invoked by the swings in the market, it is critical that our decision making remains focused and that we maintain a disciplined investment approach. The silver lining is that the price declines that could come with these risks will likely generate good buying opportunities, and allow us to generate better long-term returns. As always, we are here to discuss any questions or concerns you may have. Enjoy the rest of your summer.


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Entrees For The “Sandwich Generation”

Bob and Marcy Tannenbaum both have hectic lifestyles. Bob, who is 45, works in the city for a public relations firm. He commutes from the suburbs each day. Marcy, who is employed closer to home, is the director of a nonprofit organization. She’ll turn 43 before the end of the year. They’re making ends meet, but haven’t set aside nearly as much as they’d like for their future needs.

The couple’s three children are 15, 12, and eight. Getting them to soccer practices, dance recitals, and religious-education sessions keeps their parents hopping—especially Marcy, who bears the brunt of the carpooling.

As if things weren’t complicated enough, Bob received a panicky phone call last week from his mother. Bob’s 70-year-old father had been hospitalized after taking a spill. His mother wanted Bob to come “home” immediately, but “home” is 1,000 miles away. And he can’t just leave his family and job behind—not to mention the economic ramifications if he did.

This kind of scenario is all too familiar to those stuck in the middle of helping elderly parents and raising their own children. These people have come to be known collectively as the

“sandwich generation.” And if you’re not careful in these situations, the challenges can swallow you.

Nevertheless, you may be able to minimize potential problems with advance planning. Consider these four basic steps:



1. Get all the facts. Job one is to avoid unpleasant surprises. Talk to your parents about their financial situation and their plans if they become ill or incapacitated. At the same time, examine your own

finances. If you haven’t already done so, figure out how much you’ll need to save for retirement and college for the kids. What will you have left for emergencies?

2. Seek “the power.” In case of a dire emergency, you’ll have to act fast on behalf of your parents. The best approach is to have a durable power of attorney in place. This allows you to make decisions regarding their financial considerations. For more protection, supplement a power of attorney with a health-care proxy and a living will relating to medical decisions.

3. Face up to long-term needs. The cost of an extended stay at an assisted-living facility or nursing home can be a financial back-breaker for families. Check to see what coverage, if any, your parents would receive from long-term care insurance. If they don’t have policies, examine your options. Of course, the longer someone waits to buy such a policy, the more it will cost per year.

4. Don’t forget about yourself. As much as you want to help your parents, you can’t ignore your own needs. It usually doesn’t make sense to erode a college savings or retirement fund to support your parents. Stick to your priorities and develop a plan that incorporates all of these factors. ●

Do You Understand Investments?

People who find themselves owning complex investment vehicles often leave the driving to the professionals. And that’s perfectly acceptable, but even “passengers” should have a basic understanding of how a particular investment works—especially when it’s your hard-earned money on the line.

Consider a retiree who’s looking into purchasing an annuity. Is it an investment product, an insurance product, or both? Will the annuity continue to pay income to heirs if the owner dies? Is the principal protected in case of a severe economic downturn? Surprisingly, many investors—including owners of annuities—are stumped by these basic questions.

Other commonly used terms often befuddle investors. Do you know the difference between an “annual effective yield” and an “average annual yield”? How about an “annual percentage yield”? It’s important to distinguish among different types of yield so you can make valid comparisons of investments.

Do you consider yourself an investment expert? Here are a few simple questions—with the answers below—to see how you measure up.

1. An insurance company generally begins payments under an annuity when:

- The accumulation phase begins.
- The accumulation phase ends.

- The annuity owner dies.
- The annuity owner retires.

2. Payments under a variable annuity are based on:

- Fluctuations in the current interest rate.
- Fluctuations in the current inflation rate.
- Performance of underlying stocks.
- Performance of the Standard & Poor’s (S&P) 500 index.

3. An annual effective yield is described best as:

- The annual return before interest is compounded.
- The annual return after interest is compounded.

How Much Do You Have To Save For College?

The ever-rising cost of college shows no sign of abating. According to the nonprofit College Board, tuition and fees for the 2010-2011 academic year at four-year public colleges increased on average by 7.9% from the previous year, to \$7,605, for in-state students, and by 4.6%, to \$8,535, for those from out of state. For private colleges, tuition and fees jumped an average of 4.5%, to \$27,293. And that's not counting room and board, books, supplies, and transportation, which together may add more than \$10,000 to the yearly total. At many top private schools, the annual cost now runs more than \$50,000.

So how much savings will it take for you to send your children to college when they're ready? Your expense will vary depending on what schools your kids attend, how much savings you've already set aside, any financial aid you get, and the rate of inflation for tuition prices. Still, you can get a rough idea of how much you need to save by plugging a few key assumptions into an online calculator.

Consider John and Jane Smith. The Smiths have two children, Michael, age 13, and Susan, who's eight. The kids are five and 10 years, respectively, from when they'll start college. Let's begin by assuming John and Jane haven't saved anything yet. Based on a current

tuition cost of \$15,000, a conservative expected interest rate of 3% and an expected inflation rate of 3%, in five years the cost of four years of college for Michael will be \$72,749.55. To have that much set aside when he starts his freshman year, the Smiths would need to save \$708.47 each month. Using the same assumptions, Susan's four-year tuition bill will come to \$84,336.67—and require an additional \$465.24 in monthly savings. (Keep in mind that this is for tuition only; the actual costs of sending the kids off to college will be substantially higher.)

Now let's change the scenario slightly. Suppose the Smiths have already managed to set aside \$50,000 for each child. Using the same \$15,000 annual tuition cost, the 3% expected return on their savings, and 3% inflation, the additional monthly savings needed to meet Michael's tuition costs drops to \$116.53, and just \$75.74 more each month would get Susan to her goal.

Suppose we change another variable. This time, we'll still assume the Smiths have saved \$50,000 for each child, but now they anticipate that the children will be attending schools where tuition is currently \$20,000, instead of \$15,000. We will also keep the same 3% expected interest rate for their savings and 3% annual inflation. In this case, the

overall savings goal for Michael to attend school for four years increases to \$96,999.41, and the Smiths will have to save \$352.68 per month to have that much ready when he starts college. For Susan, the savings goal increases to \$112,448.90—or \$230.82 a month during the 10 years until she reaches college age.

Finally, let's change the facts one last time. We will keep a \$20,000 tuition fee, \$50,000 of college savings per child, and an expected 3% inflation rate, but we'll double the expected interest rate from 3% to 6%. With this higher investment return, the projected savings goal to send Michael to school for four years can be achieved with monthly savings of \$208.54. The goal for Susan, who will enter college in 10 years, is reduced to just \$60.37.

Of course, these figures are hypothetical and not indicative of any particular investment. Be aware that investors also face the risk of lower returns and a loss of principal if markets decline. In addition, depending on how this money is saved, there may be tax consequences to liquidating investments to make the payments.

Keeping all of the variables in mind, you can see that making college savings a top priority is critical. You'll also need to consider what savings vehicle to use. For many families, 529 college savings plans offer compelling advantages—you won't be taxed on investment gains or when you pull out money to pay qualified college expenses, and some of these state-sponsored plans let state residents deduct contributions on their state tax returns. Financial aid formulas also tend to make smaller reductions in potential aid when savings are held in 529 plans. But other options may work better in some cases. And whatever vehicle you choose, the most important thing is to start saving as soon as possible and to be diligent about adding to your education accounts. With tuition costs likely to continue to rise faster than overall inflation, the high cost of college could move much higher in the years ahead. ●

- c) The annual return before inflation.
- d) The annual return after inflation.

4. The average annual yield often is used to:

- a) Compare the past performance of mutual funds.
- b) Distinguish Treasury bills from Treasury notes.
- c) Factor in the tax-free element of municipal bonds.
- d) Account for a guaranteed minimum-income benefit.

5. When you buy Treasury bills at auction, the rate is:

- a) Based on the current interest rate for loans.
- b) Based on the S&P 500.
- c) Equal to par.
- d) Discounted from face value.

6. A "private activity bond" is best described as:

- a) A corporate bond eligible for capital-gain treatment.
- b) A corporate bond exempt from income tax.
- c) A municipal bond that is completely taxable.
- d) A municipal bond that can trigger alternative minimum tax (AMT) problems.

7: An exchange-traded fund (ETF):

- a) Trades like stocks.
- b) Trades like mutual funds.
- c) Involves trades between major stock exchanges.
- d) Involves trades between different currencies.

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

Compare Traditional IRAs And Roths

While traditional IRAs and Roth IRAs share several common traits, there are some stark tax differences between the original IRA and the alternative version that made its debut in 1998.

First, let's look at the traditional IRA. Subject to annual limits, contributions may be wholly or partially deductible, depending on your modified adjusted gross income (MAGI) and whether you participate in an employer-sponsored retirement plan. There's no tax on earnings until you receive distributions. However, if you make a withdrawal prior to age 59½, you must pay a 10% penalty on top of regular income tax. Also, you must begin taking annual "required minimum distributions" (RMDs) in the year after turning age 70½.

Now, let's quickly examine the Roth. As with traditional IRAs, earnings are tax-deferred, but that's pretty much where the tax similarities end. Unlike contributions to traditional IRAs, money going into a Roth is never tax-deductible, but qualified distributions from a Roth in existence at least five years are completely tax-free. And you don't have to take lifetime RMDs.

Test yourself with these questions about the two types of IRAs:

1) The contribution limit for traditional IRAs is:

- a) The same as the limit for Roth IRAs.
- b) Higher than the limit for Roth IRAs.
- c) Lower the limit for Roth IRAs.
- d) Unrelated to Roth IRAs.

2) Traditional IRA distributions are taxed at:

- a) Ordinary income rates.
- b) Capital gains rates.
- c) Special retirement plan rates.
- d) Alternative minimum tax (AMT) rates.

3) Assets in a traditional IRA can be:

- a) Rolled over tax-free to a Roth.
- b) Rolled over tax-free to a 401(k).
- c) Withdrawn tax-free upon retirement.
- d) Withdrawn tax-free upon death or disability.

4) Which of the following is NOT a qualified distribution from a Roth?

- a) Made after age 59½.
- b) Made because of death or disability.
- c) Used to pay for qualified higher education.
- d) Used to pay for a qualified home purchase.

5. Annual contributions to a Roth IRA are:

- a) Available to anyone who earns

compensation.

- b) Increased for low-income taxpayers.
- c) Phased out for high-income taxpayers.
- d) Limited if you participate in a retirement plan.

6. Which of the following statements is true?

- a) You can't contribute to a Roth IRA before age 59½.
- b) You can't take distributions from a traditional IRA before age 59½.
- c) You can't contribute to a traditional IRA after age 70½.
- d) You can't take distributions from a Roth after age 70½.

7. Which of the following statements about Roth distributions is true?

- a) Pre-age 59½ distributions are 100% taxable.
- b) Post-age 70½ distributions are 50% taxable.
- c) Distributions within five years are 25% taxable.
- d) Nonqualified distributions may be partially tax-free.

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

Reap What You Sow

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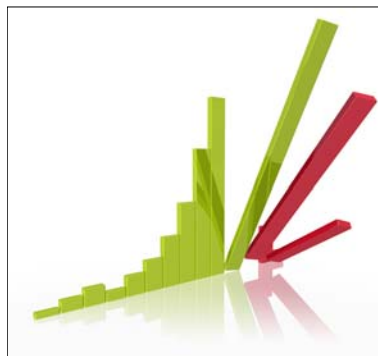
2. The ordinary income-tax rates also are scheduled to go up in 2013. The current top tax rates of 33% and 35% will be bumped up to 36% and 39.6%, respectively, and rates for lower brackets also will increase.

3. Beginning in 2013, an additional 3.8% Medicare surtax will apply to the lesser of your net investment income for the year or the amount by which your modified adjusted gross income (MAGI) exceeds \$250,000 (\$200,000 for single filers).

These tax increases are, of course, subject to change if Congress acts. However, as things stand now, a high-income investor could be looking at an effective tax rate of 23.8% percent on

long-term capital gains. And the tax rate for short-term gains could be as high as 43.4%!

Knowing what's ahead, you may be able to devise investment strategies that maximize the potential tax benefits of the situation. For instance, if it makes sense from an investment point of view, you may want to harvest tax losses soon enough to have them qualify as short term—so that they offset short-term rather than long-term gains. That way, you won't negate any of the preferential tax treatment of long-term gains.



On the flip side, if you're in a position to take capital gains, you should realize short-term gains to offset long-term losses. Once again, you don't

want to waste the benefit of paying a maximum tax rate of only 15% on your long-term gains this year. Unlike in most other years, you might emphasize harvesting gains instead of losses in 2012.

Naturally, these investment moves can't be made in a

vacuum. But this should give you considerable food for thought. The best approach is to develop a logical plan, with our assistance. ●