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Enter The Five Dimensions Of Federal Income Taxes

There's more to the federal income tax system than just a single calculation. In fact, upper-income taxpayers—especially those generating income from investments—actually must cope with five "dimensions" of taxation: (1) ordinary income tax; (2) capital gains and losses; (3) the alternative minimum tax; (4) the net investment income tax; and (5) a reduction of itemized deductions and personal exemptions. Here's a quick rundown:

1. Ordinary income tax. This is the standard tax calculation we're all familiar with. The income you earn generally is taxed under a graduated rate structure with seven tax brackets: 10%; 15%; 25%; 28%; 33%; 35%; and 39.6%. If you're in the top tax bracket, any extra income you earn is taxed at the 39.6% rate. Tax deductions and credits can be used to offset your tax liability based on these ordinary income rates, but certain special rules may apply (see #5).

Furthermore, under the "kiddie tax," if investment income of a dependent child exceeds an annual threshold ($2,000 in 2014), the excess generally is taxed at the top tax rate of the parents. This can hike the overall family tax bill.

2. Capital gains and losses. The tax law provides separate tax treatment for capital assets such as securities and real estate. Generally, gains and losses from capital assets are used to offset each other. Long-term gains from assets held longer than a year qualify for a maximum 15% tax rate, but the rate increases to 20% for those in the top two ordinary income tax brackets. Qualified dividends also benefit from these preferential tax rates.

In addition, you can use excess capital losses to offset up to $3,000 of ordinary income, and you can carry additional losses over to next year. With that in mind, "harvesting" losses is a common year-end tax strategy.

3. Alternative minimum tax. The alternative minimum tax (AMT) runs on a track parallel to ordinary income tax. This complex calculation involves certain additions and adjustments before subtracting an exemption amount based on your tax filing status. However, the exemption is reduced for high-income earners. There are just two tax brackets—26% and 28%—for taxpayers with AMT liability.

At tax return time, you compare your ordinary income tax result to the AMT result and effectively pay the higher of the two. This "alternative" tax often catches unwary taxpayers by surprise.

4. Net investment income tax. The "net investment income" (NII) tax is a new wrinkle that taxpayers have to deal with for the 2013 tax year and beyond. You must pay a 3.8% Medicare surtax on the lesser of your

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SPRING AHEAD?

Global markets experienced a choppy quarter but ended mostly positive amidst the continued slow economic recovery in the United States and Europe, the change in leadership at the Federal Reserve, as well as developments such as Russia's annexation of Crimea and further evidence that China's growth is slowing. U.S. economic growth was complicated by severe winter weather that likely depressed some of the short-term indicators of the economy's health. Overall, though, the picture remains one of modest but steady growth with a noteworthy rebound in housing alongside persistently slow-to-recover employment. Stocks cooled from last year's pace but posted small gains for the quarter. Core and municipal bonds were among the quarter's stronger performers, reinforcing the important role they can play during uncertain times.

Overall, we remain mindful that we have not yet achieved "normal" economic status. Risks remain, whether they are geopolitical, a potential slowdown in China's economy or how the Fed will unwind its large balance sheet without major market upheaval.

Five years after the worst financial crisis since the Great Depression, we feel fortunate to be where we are today. Households have brought down debt levels at a faster pace than expected and household balance sheets have improved significantly as the housing and stock markets have risen.

As always, we appreciate your confidence and welcome questions about your individual situation.

When Two Out Of Three Ain't Bad

From a tax perspective, a dream retirement account probably would encompass three elements:

1. Contributions to the account would be tax-deductible.
2. Accumulation of earnings within the account would be tax-deferred.
3. Distributions from the account would be tax-free.

Of course, there's no such animal, but various types of accounts can deliver two of those three elements. And two out of three ain't bad.

For instance, if you establish a traditional IRA, you may be able to deduct contributions to the account, especially early in your career when your income is lower. However, deductions for contributions are phased out if you (or your spouse) participate in a retirement plan at work and your income exceeds a specified level. Nevertheless, any earnings inside the IRA will continue to grow without erosion by taxes until the money is withdrawn.

When you take distributions from a traditional IRA, the portion of the withdrawal representing deductible contributions and earnings will be taxed at ordinary income rates. You also might owe a 10% tax penalty on the taxable portion of distributions you take before age 59½. Finally, after you hit age 70½, you'll have to take "required minimum distributions" (RMDs) each year.

Generally, your contributions to a 401(k) or another kind of "qualified" workplace retirement plan are exempt from taxes up to a specified annual maximum, and earnings inside your account continue to build up tax-deferred, just as they do with a traditional IRA. But here, too, your distributions from the plan will be taxable at ordinary income rates on a pro-rata basis—that is, you'll be taxed on the portion of each withdrawal that represents pre-tax contributions and the earnings they generate. But if you change jobs or retire, you could make a tax-free rollover into another qualified plan or an IRA. As with traditional IRAs, distributions from workplace plans prior to age 59½ are normally subject to a 10% tax penalty, and the rules for RMDs also apply to these plans unless you're still working full-time.

With a Roth IRA, contributions are never deductible, but any earnings in the account will grow tax-deferred. Even better, for a Roth you've had for at least five years, distributions after age 59½ are tax-free. If you make a withdrawal within the first five years, account earnings will be taxed at ordinary income rates but you'll be allowed a tax-free return of contributions.

Unlike traditional IRAs and qualified plans, a Roth IRA doesn't force you to take RMDs during your lifetime. That means you can pass along all of the account's assets to your heirs.

Because there's no dream plan that offers all three desirable attributes, you could choose to combine different kinds of accounts to get a blend of tax benefits. ●

Markets May Not Be Certain, But Experience Is

Have you ever wished you could do it all over again? Experience can be a great teacher, and it's natural to imagine that with the benefit of hindsight you would have made better decisions about everything from raising your children to managing your financial affairs. And while that may or may not be true, what is certain is that you can offer younger family members some of the insight you've acquired along the way.

Here are some thoughts you might pass along:

1. When you get a pay raise or a new higher-paying job, consider earmarking at least part of the additional money for retirement savings. You'll be amazed by what tax-deferred compounding can do to even relatively small sums over the course of several decades. And using raises to increase your contribution to a 401(k) can be relatively painless. Ratchet up your saving rate by a percentage point or two each year and you'll soon reach the maximum for annual pre-tax contributions to 401(k)s and similar employer-sponsored plans—$17,500 in 2014 if you're younger than age 50. Beginning at 50, you'll be eligible to contribute an extra $5,500 a year.

2. Try to resist the siren song of early retirement. Leaving your job in your 50s may be tempting, but it runs counter to several financial realities. Most people have not saved enough to retire comfortably even at the traditional age of 65, and quitting early can mortgage your future in two ways—reducing the amount you can save while extending the time that your savings must support you. By the same token, however, every year you keep working improves your situation. Moreover, as life expectancies increase, more and more people find they want to stay on the job at least part-time, and not only for financial reasons. Working can help keep you engaged and healthy,

Figure Your Investment Risk And Cope With It

Are you a risk-taker? To realize rewards, you usually have to take some risks, especially when it comes to finances. But beyond understanding that investment risk and reward go hand in hand, it's important to know how they relate. What is the nature of risk, and how can you handle the different kinds of risk that could affect the performance of your investments?

What is the nature of risk? For many investors, risk is associated with the inherent volatility of the equities markets. You run the risk that your investments will perform worse this year than last year or worse than you anticipated or worse than the markets as a whole.

Risk means you have something to lose—the money you've put into a particular investment or the money you might have made if you had made different choices. You also could run the risk of throwing good money after bad, of buying more of something when the price is low only to see the value fall further.

Although risk and reward are related, there's no direct, predictable connection between the two. You could decide to take fewer risks and still lose money, or you might ratchet up your investment risk without cashing in on higher returns. Nevertheless, it's important to try to keep risk and reward in a balance that fits your situation.

What are the main types of risks? Financial experts often debate this question, but the pros generally agree that two significant risks facing investors are inflation and emotion.

1. Inflation risk. Essentially, this is the risk that money you earn will lose some of its purchasing power over time. For example, if you buy a five-year certificate of deposit (CD) from a reputable bank, there's relatively little risk that the bank won't live up to the terms of the CD. But there's a much bigger risk that the dollars you receive in five years won't buy as much as they would now.

If you're old enough to have experienced the 1980s, you might recall the days when money market funds paid interest at double-digit percentage rates. However, with double-digit inflation occurring at the same time, most savers barely stayed even.

Inflation risk can present problems to all investors, and especially to retirees. Someone who left work in 1978 might have felt pretty comfortable with a pension paying $40,000 a year. But that $40,000 was worth only about $12,200 in 2013, according to the Bureau of Labor Statistics. This represents a loss of almost three-quarters of the money's buying power.

One way to protect against inflation risk is to include an appropriate ratio of stocks and stock funds in your portfolio. Or, if you're more conservative, you might consider inflation-protection bonds. History has shown, however, that holding even a modest equity stake may increase returns without undue risk when compared to a pure fixed-income portfolio.

2. Emotional risk. It's easy to let emotions rule decision-making. Almost everyone is subject to bouts of fear and greed, and investors have an innate tendency to be overconfident about their ability to choose winning positions. But simply doing what feels right—or avoiding what feels wrong—can lead to adverse results.

Consider an investor who sits on the sidelines during a bull market, nervous about following the crowd—a tendency that indeed can be counterproductive. But finally the investor gets tired of losing out and jumps in, buying at the top of the market and without carefully considering the fundamentals of particular investments. Others get into trouble when the market is falling and they sell solid holdings in a panic, losing out on the chance to benefit when they rebound.

The best protection against emotion is to have a carefully considered investment plan and to try to stick with it even when markets are highly volatile. Having a balance of bond funds for stability and income and stocks for growth can help smooth out inevitable market bumps.

How do you manage risk? Everybody has a different risk tolerance. A good approach for managing yours is to stick to investment fundamentals. That may be as simple as refocusing on the key principles of diversification and asset allocation.

Diversification spreads your investments over a broad mix of asset classes, an approach that has the potential to reduce risk. Asset allocation is the process of assigning percentages to those asset classes based on your particular needs and risk tolerance, and then rebalancing your holdings regularly to keep them close to their assigned allotments.

There's no way to avoid risk completely, but you still can generate earnings while staying within your comfort zone. We're here to provide guidance. ●

particularly if you find something you really like to do.

3. Consider postponing Social Security. You can begin receiving benefits as early as age 62, but each year you delay will increase the amount of your monthly payment, and if you wait until age 70, you'll get 76% more than if you had started drawing benefits at 62. And most people will live long enough to get a larger total payout if they begin later.

4. Don't feel like you have to go it alone in making financial decisions. Working with an advisor could help you make sense of complex financial markets and chart a comfortable path toward your goals. The right advisor can assist you in deciding how much to save, how to allocate your investments, how to weigh the pros and cons of buying a home and other major financial choices, and, when the time comes, how to deploy your retirement nest egg. ●

Auto Enrollment: Boom Or Bust?

The trend toward using an "automatic enrollment" feature in 401(k) plans is having one desired effect, leading to more employees participating in such plans. With automatic enrollment, you are considered to have signed up for an employer-sponsored retirement plan as long as you don't actively opt out. Yet while participating in your company's 401(k) is almost always a good idea, other aspects of automatic enrollment may be less beneficial.

With a 401(k) plan, you can defer salary to your retirement account on a pre-tax basis, up to generous limits in the law. You can choose to defer as much as $17,500 in 2014, or $23,000 if you're age 50 or older. Often, too, participants will be eligible for "matching contributions" from their employers, based on a percentage of compensation.

However, if you're classified as a highly compensated employee (HCE), strict nondiscrimination rules could limit your participation in the plan. For example, plans must pass an actual deferral percentage test for employee contributions and an actual contribution percentage test for employer contributions. If a plan fails those tests, the amount you're allowed to contribute will be restricted.

Frequently, the figures are skewed by new hires who don't elect to participate in a plan. In addition, other employees may still be gun-shy about participating after the last economic downturn. The end result is bad news for HCEs.

That's where the automatic enrollment feature can come to the rescue. Because employees must actively choose to opt out of the plan if they don't want to participate, more tend to stay in the plan, and it's likely that a higher percentage of non-HCEs will participate than would join a plan without automatic enrollment. That could reduce the chance that there will be extra limits on contributions by HCEs.

But what if you're at the lower end of the salary scale? Automatic enrollment may get you into your company's 401(k), but employers sometimes try to encourage participation by limiting the "default rate" of salary deferral for employees who don't choose their own rate. Stick with the default rate, which might be as low as 3%, and you're likely not to set aside enough to fund your retirement.

In addition, plans with automatic enrollment may include a default investment allocation that may not fit your needs.

In the case of both of these features, the solution could be to go beyond the default options, choosing to contribute more and to put the money in other kinds of investments. Young people who have several decades until retirement, for example, might choose to emphasis stock funds that have the potential to provide higher returns than they might earn in less aggressive investments. ●

Five Dimensions

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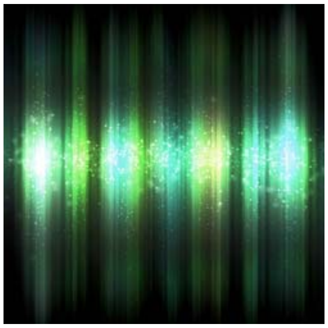
NII or your modified adjusted gross income (MAGI) above an annual threshold—$200,000 for single filers and $250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. But some items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans, are excluded from the definition.

The NII tax is an add-on to the ordinary income tax calculation. Thus, your combined top tax rate can be as high as 43.4%!

5. Reduction of itemized deductions and personal exemptions. Two tax law provisions that were reinstated in 2013 may affect upper-income taxpayers adversely. Under the "Pease rule" (named for the congressman who originated it), certain itemized deductions, including those for charitable donations, state income tax, and mortgage interest, are reduced if your adjusted gross income (AGI) exceeds an annual threshold. For 2014, the threshold is $254,200 of AGI for single filers and $305,050 for joint filers. The total of your itemized deductions covered by the Pease rule is reduced by 3% of the amount above the AGI threshold, but not by more than 80% overall.



A similar rule phases out the tax benefit of personal exemptions. Under the personal exemption phaseout (PEP) rule, exemptions are reduced by 2% for each $2,500 (or portion thereof) of your AGI that exceeds an annual threshold. The PEP thresholds are the same as those for the Pease rule.

Beyond these five, a sixth dimension exists for most taxpayers—state income taxes. ●