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New 3.8% Medicare Surtax Spurs Year-End Action

No one ever said year-end tax planning in 2012 would be easy. For starters, the elimination of the "Bush tax cuts" will result in higher federal tax rates for income, capital gains, and dividends, beginning in 2013 (unless Congress enacts new legislation). But there's another major tax change in store for next year: a new 3.8% surtax that will hit some high-income investors.

The 3.8% Medicare surtax applies to the lesser of your "net investment income" or the amount by which your modified adjusted gross income (MAGI) exceeds either $200,000 for single tax filers or $250,000 for joint filers. Net investment income includes interest, dividends, royalties, rents, gains from sales of property (other than property held in an active trade or business), and income from passive activities, but not tax-exempt interest or distributions from IRAs and qualified retirement plans.

Facing this prospect, high-income investors may want to take steps before the end of this year to reduce the sting of the surtax next year. Here are several ideas to consider:

• **Sell assets soon or hold on.** If the law doesn't change before 2013, you might decide to sell stocks, rental real estate, or other assets in 2012. That will help you avoid both the higher tax rates on capital gains and the 3.8% surtax that will kick in next year. Of course, any asset sale also needs to make sense from a financial perspective. If you decide to hold on to most of your investments for now you could still sell them later during a year in which your income is relatively low (and you'll be in a lower tax bracket).

• **Sell property on an installment sale basis.** If you've decided to sell property such as rental real estate and you have a good offer in hand, you might arrange an installment sale. As the name implies, the buyer will make regular payments over two or more years. (Most buyers will agree to this gladly.) By paying capital gains tax only on the portion of the payment received in a particular year, you'll spread out the tax liability and you may be able to stay below the threshold for triggering the 3.8% surtax. Alternatively, you can elect to be taxed on the entire gain in the year of the sale.

• **"Hide" income in IRS-approved tax shelters.** It's a myth that there are no more tax shelters. For instance, if you invest in life insurance or annuities, you don't owe any current tax on the funds building up in your account. Life insurance proceeds aren't paid until the insured person dies, while a deferred annuity may let you "leapfrog" your high-income years and receive taxable distributions when you're earning less. Also, income from municipal bonds is completely free of federal income tax. Other investment opportunities, such as rental real estate and oil gas and deals, may provide tax

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Where There's A Living Will, There's A Way

Will your family members know how to handle a life-threatening illness or injury involving a loved one? A "living will" can point them in the right direction.

Simply put, a living will is a legal document that establishes guidelines for prolonging or ending medical treatment. It's important to have a living will created for yourself, and for relatives such as your spouse and parents, to inform health-care providers in case of a medical emergency or terminal illness.

A living will indicates the types of medical treatments you want or do not want applied in the event you suffer a terminal illness or fall into a permanent vegetative state. Such a will doesn't become effective unless you're incapacitated. Typically, a physician must certify that you have a terminal illness or that you're permanently unconscious.

To cover situations in which someone is incapacitated and can't speak, yet the condition isn't so dire that the living will becomes effective, you can execute a health-care power of attorney or health care proxy.

The requirements for living wills vary from state to state. Have an attorney who is experienced in these matters prepare the living will based on applicable laws. The best approach is to coordinate your living will with your regular will, any trusts or powers of attorney you may have, and other estate-planning documents.

Robert J. Pyle, CFP, CFA

Avoid Five Pitfalls In Refinancing

Mortgage interest rates are at historic lows, but does that mean you should refinance an existing mortgage? A "refi" may pay off, but you should consider all of the relevant factors, including these five potential problems:

1. You're back to square one. Starting over is hard to do if you're close to paying off a mortgage. For instance, if you take out a 30-year loan, the monthly payments in the first seven years will reduce your principal by only 5% or so, with the rest going to interest. Instead of beginning to make a dent in their principal debt, homeowners who refinance after seven years are effectively starting from scratch. Figure out how much you're really saving if you shave only a percentage point or less off your current rate.

2. Closing costs can pile up. Depending on how long you stay in a home, the expenses of a new loan can outpace the savings. Figure on closing costs equal to about 1.5% of the mortgage amount. Then calculate your monthly savings to see how long it will take you to break even on the cost of the mortgage. For example, if you refinance a $300,000 mortgage, closing costs will run about $4,500. If the new mortgage interest rate is 1 percentage point lower than your current rate, you will save $178 a month and will need just over 25 months to recoup your closing costs. So if you're not planning to stay in the house for more than two years, you could end up losing money. Reduce these costs by paying the prepaid items out of pocket. You'll get that money back when the escrow accounts on your old loan are paid back to you.

3. Terms can be confusing. With refis so popular now, they can take a long time to process, and it may not be clear when you should stop paying your current mortgage. If you inadvertently fall behind, it could throw a monkey wrench into the works. Generally, lenders offer a two-week grace period after a mortgage payment is due and then charge a 5% penalty. Even worse, your credit score might plummet by 100 points or more if you're 30 days past due—and that change could affect your refi.

4. The appraisal may be too low. Before the refi is approved, the lender will require an independent appraisal to confirm the home's value. The numbers now are trending lower than expected for many homeowners, especially those who reside in areas hit by numerous foreclosures. If the appraised value is too low and you don't have enough equity in the home, the lender could raise the rate or deny the loan altogether.

5. You could pay hidden fees. Under federal law, lenders must provide a good-faith estimate of the fees needed to complete the refi, and that statement could reveal costs you hadn't expected. Also, some low-interest mortgages require you to pay "points," and each point is equal to 1% of the mortgage amount. That could delay your break-even point even longer. ●

Splitting Income With Your Family

Shifting taxable income to other family members—usually children or grandchildren—who are in lower tax brackets is a time-tested tax planning technique. It may enable you to reduce overall taxes for your family. But this strategy could be especially valuable now. Barring last-minute changes from Congress, tax rates on ordinary income will be adjusted upward in 2013. At the same time, favorable tax breaks for capital gains and dividends will be scaled back.

If you own income-producing property, such as securities or real estate, you're taxed on the income from those assets in your own higher tax bracket. But your children and grandchildren are likely to be taxed at lower rates, and if you can shift tax liability for the property to the younger generations, your family will pay less in taxes.

Typically, you might give the property to a family member through a direct gift. More sophisticated arrangements may involve the use of a trust. Either way, income from the property is taxed to the family member in a lower tax bracket instead of to you in your higher bracket.

What makes this strategy even more attractive now is that tax rates are going up. In 2012, ordinary income is taxed under a six-rate structure with a top rate of 35%. Also, the maximum tax rate for long-term capital gains and dividends is 15%, reduced to 0% for those in the 10% and 15% ordinary income brackets. Absent new legislation, the tax rate structure for 2013 will be adjusted to reflect five brackets and a top rate of 39.6%. The maximum tax rate on net long-term capital gains is set to increase to 20% for most taxpayers and to 10% for investors in the 15% tax bracket (the lowest under the new rules). Qualified dividends will be taxed at ordinary income rates.

Putting Your 401(k) Plan On Automatic Pilot

For business owners who need to jump-start their retirement savings, government tax rules can help. For instance, if you've implemented a 401(k) plan for your company, you can set aside amounts each year in your personal account up to generous annual levels. And, to sweeten the pot, your company can add "matching contributions" based on a percentage of your salary.

Not a bad deal, right? All of the contributions—both yours and the company's—are able to compound without any current erosion by tax payments. That can help you build a good-sized nest egg within a relatively short period.

But there's a potential obstacle for some high-income business owners. To qualify for favorable tax treatment, your 401(k) plan must satisfy strict nondiscrimination requirements. The contributions to your account could be curbed if the company's participation levels don't meet the standards. That's where an "automatic enrollment" feature can come to the rescue of your plan.

As a general rule, the maximum amount an employee can elect to defer to a 401(k) plan in 2012 is $17,000. The deferral limit is $22,500 for anyone age 50 or older. Also, the full amount of contributions, including any deductible matching contributions by the company, can't exceed $50,000, or 25% of your compensation, whichever is less. Finally, the maximum amount of compensation that can be taken into account for these purposes is $250,000. (All of these dollar figures are indexed annually for inflation.)

So, suppose you earn $200,000 a year and you're age 55. Your company provides a matching contribution equal to 5% of salary. Based on the tax-law limits, you can set aside as much as $32,500 ($22,500 + $10,000 in matching contribution) in your account in 2012.

However, the nondiscrimination rules for 401(k) plans are particularly stringent. For starters, the plan must adhere to the usual participation, coverage, and vesting rules that apply to all other tax-qualified plans. Furthermore, a 401(k) plan must pass both an "actual deferral percentage" (ADP) test and an "actual contribution percentage" (ACP) test. Both tests are designed to ensure that the plan doesn't unfairly favor highly compensated employees (HCEs).

For 2012, an HCE is defined as someone who:

- Owned 5% or more of the company at any time during 2011 or 2012; or
- Received more than $110,000 in compensation during 2011 and is in the top 20% of the company's employees based upon compensation.

Note that the indexed HCE compensation limit for 2012 is $115,000. Because the definition involves a "look-back" to the prior year, the $115,000 limit for 2012 will be used for plan testing in 2013.

If the 401(k) plan fails either the ACP or the ADP test, the company must make corrective distributions to HCEs, effectively limiting their contributions, or kick in extra contributions for non-HCEs. But employers may take advantage of a special "safe-harbor" rule: The nondiscrimination requirements are satisfied if the company provides minimum contributions of at least 3% of compensation to its non-HCEs.

If participation levels for your company's plan don't fall within these parameters, it could cause problems for you or the business. Younger workers might not be inclined to defer salary to an account to which they generally won't have access for decades. And, in the wake of the stock market downturn of 2008-2009, other employees may be reluctant to invest at all. Such concerns have led employers to search for new ways to encourage participation in their 401(k) plans.

One solution may be to install an automatic enrollment feature. With this provision, employees are enrolled automatically in the 401(k) plan unless they choose not to be, instead of the other way around. Thus, the "default option" becomes plan enrollment. Human nature being what it is, more employees are likely to participate under this setup—and as a result you and the HCEs in your company may be able to sock away more for retirement.

The government is fully on board with automatic enrollment. In fact, recent liberalizations in the Pension Protection Act of 2006 (PPA) are designed to encourage its use. Under the PPA, employers may limit automatic enrollment to new hires or extend it to the existing staff. In addition, the PPA makes it easier for employers to increase the percentage of salary allocated to employee accounts automatically. Automatic enrollment, which can be added to your plan with relative ease, could end up helping you save more for retirement. ●

Suppose you own property that produces annual income of $20,000. If you're in the top bracket in 2013, you'll pay $7,920 in tax on the income (39.6% of $20,000). But a child in the 15% tax bracket would owe tax of only $3,000 (15% of $20,000) on the same income—$4,920 less.

There are other tax ramifications to consider, however. A transfer of property is subject to gift tax, although you're allowed an annual gift tax exclusion ($13,000 per recipient in 2012) as well as a lifetime exemption (for combined lifetime and estate gifts) of $5.12 million in 2012. The biggest impediment to this strategy may be the "kiddie tax," which applies to investment income above an annual limit ($1,900 in 2012) for a child under age 19 or a full-time student under age 24. In those cases, income that exceeds the threshold will be taxed at the top rate of the child's parent.

Finally, remember that you're giving up ownership of property when you transfer it to family members. The best approach is to incorporate income-splitting into an overall plan. ●

30 Documents For Peace Of Mind

What would happen if you were travelling abroad and had a medical emergency? Would emergency medical personnel have access to information about your allergies and medical history?

If your home is hit by a fire or natural disaster, will there be safe copies somewhere else with information about your mortgage, marriage certificate, and property?

If you succumb to an injury or are suddenly stricken by a fatal illness, will your loved ones know whom to contact, your final wishes, and where all your personal and financial records are stored?

None of these situations is pleasant to think about, of course. But our firm is here to help you address these issues. There are about 30 key documents ranging from complex trust arrangements to a simple contact list that can provide you with peace of mind and be crucial in a family emergency.

So we recently began utilizing a secure online vault created expressly for private wealth advisors.

Our firm has absorbed the expense of this online vault system to provide you and your family with a way to store personal financial data securely not only because we believe that transparency about your financial situation will strengthen our relationship with you by keeping you fully informed, but also because we are certain this vault will help you organize your personal records in case of a family emergency.

In case of a medical emergency, for example, a wallet in your card can provide doctors with a URL where they can download a detailed medical history. In case you become incapacitated, your medical proxy can be obtained. And, in case of a death, loved ones have access to crucial records about financial accounts, trusted advisors, and final wishes.

Unlike many online storage solutions, this one is encrypted always — when information is uploaded, downloaded, or stored. In addition, "strong" passwords using non-alphanumeric characters are required and the system is monitored 24/7 by an independent third-party application for intrusion detection and prevention. The system includes workflows and features specifically for private wealth advisors, which will improve our communications with your personally and eliminate the use of non-secure emails to transmit personal data.

One feature of the system that can be particularly useful to families is its collaboration settings. Parents or grandparents can provide children access to different folders. So the beneficiary can be given access to a folder about a trust but might not be able to access other folders. Children can also be given access to portfolio data on parents' accounts, which often becomes wise as family members age.

The online vault contains "help" videos but is intuitive enough for most computer users to figure out how to use it without instructions. If you would like us to upload documents to the vault for you or show you how to do it, or if you have any special instructions in the way we set up a vault for you, please call our office to let us know. ●

Surtax Spurs Yea-End Action

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breaks that reduce net investment income for purposes of the 3.8% surtax.

• **Convert to a Roth IRA.** The usual payoff for converting funds in a traditional IRA to a Roth is that future distributions can be 100% tax-free. But you have to pay current tax on the value of the assets you move into the new account. By converting before the 3.8% surtax hits in 2013, you can reduce the overall tax bite. Or you could decide to make the conversion over several years to minimize the effect on your income (and your tax rate).

• **Establish a charitable remainder trust (CRT).** A CRT lets you transfer assets to a trust that eventually will benefit a designated charity—and that will, in the meantime, provide income to a beneficiary you designate. The beneficiary receives income from the assets over the trust term, thereby spreading out the tax liability and reducing the likelihood that the beneficiary will be subject to the surtax. When the term expires, the remainder goes to the charity. Just keep in mind that this is a complex arrangement that needs to be considered as part of your overall estate plan.

• **Put family members on the payroll.** Remember that "net investment income" includes income from sales of passive investments—but not from property that's part of an active trade or business. By hiring younger family members to work for your firm, you can significantly reduce their "net investment income" for the surtax calculation. The savings can be enormous for those involved with highly valued businesses. Of course, the family members must perform bona fide duties.

These are just several ideas for minimizing the impact of the 3.8% Medicare surtax. We can work with your tax advisor and your attorney to help you plan steps that make sense in your situation. ●

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