*The*
# FINANCIAL UPDATE

Third Quarter 2012 NAPFA - Registered Financial Advisor (478) 474-7480

# 10 Top Tax Breaks Set To Disappear After 2012

The congressional "Super Committee" formed last year to iron out tax differences failed to do its job. So where does that leave us? Barring any legislative action between now and the end of the year, several favorable tax provisions for individuals and small business owners will be wiped off the books or scaled back beginning in 2013. Here's a quick rundown of 10 tax breaks that could vanish right before your eyes:

**1. Low income tax rates.** Federal income tax rates are scheduled to increase next year. For starters, the income levels for all tax brackets will be adjusted upward, while the "marriage penalty" for joint filers also will be increased. The news is especially bad for high-income earners. The two top tax rates of 33% and 35% will be replaced by rates of 36% and 39.6%, respectively.

**2. Bargain rates for capital gains and dividends.** Prior to 2003, long-term capital gains were taxed at a 20% rate, and dividends were treated as ordinary income. Under the Bush tax cuts and subsequent extensions, the maximum tax rate for long-term capital gains and qualified dividends for 2012 is 15%. The rate is 0% for certain low-income investors in the "bargain tax brackets." For 2013, the maximum long-term capital gain rate is 20% (10% for those in the lowest tax brackets), while qualified dividends once again will be taxed at ordinary income rates.

**3. Section 179 deductions.** Section 179 of the tax code gives business owners an immediate write-off for the cost of qualified property up to a specified annual level. Otherwise, the cost of property must be depreciated over time. The maximum allowance has varied in recent years, but you can deduct up $139,000 in 2012, subject to a phase-out for purchases exceeding $560,000. Unless Congress acts again, the maximum allowance will plummet to $25,000 in 2013, with only a $200,000 threshold.

**4. "Bonus" depreciation deductions.** Typically, bonus depreciation for qualified property is claimed in conjunction with a Section 179 deduction. (Unlike Section 179 deductions, bonus depreciation is available only for new property.) Although you could have claimed 100% bonus depreciation in 2011, this year there still is 50% bonus depreciation for property placed in service before 2013.

**5. Payroll tax holiday.** The so-called payroll tax holiday, a 2 percentage point reduction in federal payroll tax for employees, initially was intended to be in effect only for 2011. (A comparable tax break was created for self-employed individuals.) Then the payroll tax holiday was extended through 2012. As things stand now, you'll pay an additional 2% tax on wages in 2013.

**6. American Opportunity Tax Credit (AOTC).** Formerly called the Hope Scholarship credit, this enhanced credit may be claimed by parents who pay college tuition for their children,

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## *Wall Street Predictions For The Year*

We read an article in *Advisor Perspectives* dated August 23, 2012, showing an updated snapshot of where various Wall Street strategists think the S&P 500 will end the year.

Of the 12 major firms listed, the highest prediction is 1,490 for year-end and the lowest is 1,167. Based on the price level at the time the article was written, this represented a change from the current price of positive 5.7% or negative 17%. The average was a decrease of 1.7%. This illustrates how extremely difficult it is to predict the markets.

If you would like to read the entire article, you can find a link to it in our August 29, 2012, blog on our website at www.dayandennis.com.

Each Wednesday, we summarize several articles that we have read over the past week that we think you will find of interest and provide a link to those articles if you would like to read them in detail.

On our website you also can sign up for weekly emails of our blog.

John R Day  Bill Ennis

# 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

# 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

# Was Economic-Cycle Predictor Wrong?

The Economic Cycle Research Institute on September 30, 2011, predicted the economy would fall into a recession, but six months later the economy continued growing, albeit slowly.

ECRI is a distinguished predictor of economic downturns and recoveries whose research is relied on by Fortune 500 companies and institutional investors, but nine months after it made its highly publicized call it appears to be wrong. Still, the Institute has not thrown in the towel on its prediction. To the contrary, it's doubled up on its bet.

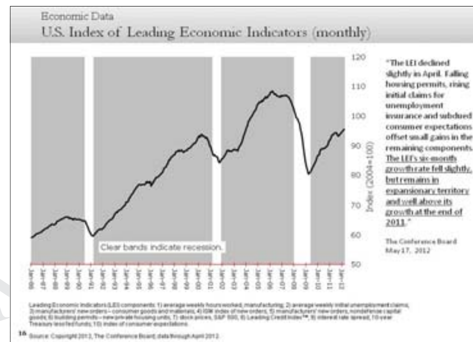
"As students of the business cycle, we admit to being hopelessly biased in our belief that it is simply not possible to repeal recessions in market economies," ECRI said in a late May 2012 blog post. "It is not whether there will be a recession, but when. And ECRI's indicators are telling us that a recession is likely to begin by midyear, if not sooner, though this may not become obvious until the end of the year."

If ECRI was indeed wrong on its call, it's a big deal for economists because ECRI's methodology and experience in predicting economic ups and downs are followed so widely. According to *The New York Times*, "Over the last 15 years, [ECRI] has gotten all of its recession calls right, while issuing no false alarms."

ECRI was founded in 1996 by Geoffrey H. Moore, who had researched the problems of predicting economic cycles since 1950. In 1958, he developed the Index of Leading Economic Indicators. In 1968, Moore gave the Index to the U.S. Government, which in 1995 selected The Conference Board to produce the U.S. Leading Economic Index (LEI).

In 1979, Moore set up the Center for International Business Cycle Research at Rutgers University, which was relocated to Columbia University in 1983. In 1996, he founded the Economic Cycle Research Institute (ECRI) in New York, where he continued to direct research into business cycles. ECRI embodied Moore's work until his death in 2000. ECRI, an independent for-profit research provider, endeavors to improve on the LEI. Economist Lakshman Achuthan, a cofounder of ECRI, has carried on Moore's work.

In a fascinating twist in June 2012, the LEI managed by The Conference Board was not predicting a recession,




while ECRI nine months earlier had said a recession was imminent and was sticking to that prediction — even as events argued against a recession coming about.

"In the past 222 years, the U.S. economy has experienced 47 recessions," ECRI said in a May 2012 blog post. "So, are we to now believe that if the Fed prints enough money, it can postpone the 48th recession indefinitely? Is it plausible that, in an era of deleveraging and very weak income growth, more money printing and borrowing will increase consumption enough to keep the economy out of recession?"

The divergence of ECRI's predictive index from the LEI has been discussed in detail by economist Fritz Meyer. Meyer asserts that "time's run out" on ECRI's September 30 call of recession and will be recorded as "a pretty glaring mistake."

Moreover, ECRI's index in early June 2012 took a negative turn for three weeks in a row while its predecessor, the LEI published by The Conference Board, was holding up. Meyer says the LEI historically has dipped well in advance of previous recessions, but such a dip was not seen in the LEI in mid-June.

In fairness to ECRI, not only can it take up to nine months for one of its calls to come about, but it can take another six or nine months for conditions to show up on economic data.

ECRI could turn out ultimately to be correct, but — happily — it's not looking that way for its last recession call. The episode illustrates the hazards of predicting economic ups and downs, a relatively new science that is likely to take miscalls for another generation or two before it becomes more reliable. ●

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. ●

# 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. ●

## Tax Breaks Set To Disappear

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subject to a phase-out rule based on modified adjusted gross income. A maximum $2,500 AOTC is allowed for 2012. However, the maximum AOTC is scheduled to drop back to $1,800 (the limit for the Hope Scholarship credit), beginning in 2013.

**7. No phase-out of itemized deductions.** Previously, most itemized deductions were subject to a special rule for high-income taxpayers. This included "big-ticket" items such as mortgage interest, charitable donations, and state and local taxes. The phase-out rule gradually was reduced, and then repealed in 2010. But now it's scheduled to reappear next year.

**8. No phase-out of dependency exemptions.** A rule similar to the phase-out of itemized deductions applied to individuals who claimed dependency exemptions, reducing tax benefits for many high-income individuals. Currently not on the books, this phase-out rule also is set to return in 2013.

**9. Enhanced child tax provisions.** Several tax benefits available to parents—including the child tax credit, the dependent care credit, and the adoption credit—will be reduced in 2013. The maximum credit amounts generally will revert to the limits established prior to 2010.

**10. Big breaks on estate and gift taxes.** Under current law, a slew of generous estate and gift tax breaks will expire after 2012. These include a $5 million combined estate and gift tax exemption ($5.12 million for 2012), a top estate tax rate of 35%, and portability of exemptions between the estates of spouses.

Unless Congress somehow manages to reach a bipartisan compromise, the law covering these taxes will revert to its 2001 form, with an exemption of only $1 million and a top estate tax rate of 55%.

Undoubtedly, the national elections will have an impact on the fate of these 10 expiring tax breaks. But you can't be certain that any or all will be extended. Try to remain flexible and plan accordingly. ●

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