The
FINANCIAL UPDATE
DAY & ENNIS, LLC
FEE-ONLY FINANCIAL PLANNING

Third Quarter 2013 NAPFA - Registered Financial Advisor (478) 474-7480

13 Midyear Tax Planning Moves To Make For '13

Now that you've put your 2012 tax return to bed, it's time to focus on 2013. Because of tax rate increases for upper-income taxpayers and a new surtax on investment income, it is especially important to get an early jump on tax planning. If you wait until the end of the year, it may be too late.

Although everyone's situation is different, and not all of these may apply to you, consider these 13 midyear tax strategies for '13:

1. Harvest capital losses. For your 2013 return, the usual 15% maximum tax rate for long-term capital gains is boosted to 20% for single filers with income above $400,000 and joint filers above $450,000. But you still can use capital losses recognized during the year to offset capital gains, plus up to $3,000 of ordinary income that now will be taxed at rates as high as 39.6%.

2. Realize capital gains. Conversely, remember that your capital gains are effectively tax-free up to the amount of your annual losses. That could be particularly valuable now that the capital gains rate is higher for some taxpayers and you also could face the new 3.8% Medicare surtax, which applies to the lesser of your net investment income or your modified adjusted gross income above $200,000 for single filers and $250,000 for joint filers.

3. Avoid the wash-sale rule. If you acquire "substantially identical" securities within 30 days of selling an investment at a loss, the loss can't be deducted on your tax return. Avoid this harsh "wash-sale" result by waiting at least 31 days to buy back the same securities. Alternatives are to buy more of the holding first and wait at least 31 days to sell the original shares or to replace them with an investment that's similar but not identical.

4. Invest in dividend-paying stocks. Qualified dividends still are taxed at a maximum 15% rate for most investors, although a 20% rate applies to those above the same income thresholds for long-term capital gains. To qualify for a favorable tax rate, you must hold the dividend-paying shares for at least 61 days.

5. Arrange an installment sale. Generally, you can defer tax on the sale of real estate or other property if you receive payments over two years or longer. Not only do you stretch out your tax payments, but you also might reduce the effective tax rate if you stay below the thresholds for capital gains and the 3.8% surtax.

6. Contribute to your 401(k). One sure-fire way to lower your tax liability is to increase contributions to a 401(k) plan where you work. For 2013, you can elect to defer as much as $17,500 to your account ($23,000 if age 50 or over). Not only do you avoid tax on the contributions, they can compound tax-free until you withdraw the money during retirement.

7. Convert to a Roth IRA. If you have funds in a traditional IRA, you can convert some or all of that money to a Roth IRA. Future "qualified" Roth

(Continued on page 4)

Importance of Diversification

Broad diversification not only helps generate reasonable returns, it protects investors in turbulent markets by helping to reduce the risk that may result in large drawdowns. Avoidable risks include holding too few securities, concentrating on single countries or industries, following market predictions, and speculating on information from rating services.

The case for broad diversification is based on studies showing no distinct patterns of return that can benefit investors. There is little predictability in asset class performance from year to year.

Asset allocation should be based on each individual's situation and tolerance for risk. It will first include core equity, with allocations to U.S. large, small and mid-size companies and international developed markets. Next, core fixed income assets are added with an emphasis on unconstrained funds and those of low duration during a time of potential rising interest rates. Finally, we allocate to satellite assets and alternatives that are less correlated to core equity and fixed income. These include real estate, international small companies, emerging market equities and bonds, high yield bond, floating rate bank debt and commodities.

As always, our plan is to help clients achieve their investment goals, while helping protect their assets in fluctuating markets.

Sincerely,
Day & Ennis, LLC

3.8% Surtax Hits Passive Investors

If you own a sizable interest in a business, you no doubt already pay close attention to the federal income taxes that your stake in the company generates. But now there's a new tax wrinkle to contend with: the 3.8% Medicare surtax on investment income. Depending on your level of business activity, you might have to pay this new tax in addition to any other federal income tax you owe.

Beginning with the 2013 tax year, the 3.8% Medicare surtax applies to the lesser of (1) net investment income (NII) or (2) the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount. That threshold is $200,000 for single filers and $250,000 for joint filers.

NII includes items such as interest, dividends, annuity distributions, rents, royalties, and net capital gains on property you sell. Significantly for business owners, it also includes income derived from passive activities. Net investment income doesn't include salaries, wages, or bonuses; distributions from IRAs or qualified plans; income used to calculate self-employment tax; gains from selling an active interest in a partnership or S corporation; and income from tax-exempt bonds and other items not subject to income tax.

As you can see, it makes a big difference for tax purposes whether you're characterized as an "active" or "passive" investor in a business. As a passive investor, the income you receive counts as NII for purposes of the 3.8% surtax.

The tax law provides some basic rules governing passive activities. Generally, a passive activity is a business activity in which you do not "materially participate." Material participation occurs when you're involved in the activity's operation on a regular, continuous, and substantial basis. Rental activities—including renting out real estate—are generally treated as passive activities, even if you materially participate. However, rental real estate activity isn't passive if you qualify as a real estate professional.

There are several tests for qualifying as a material participant. For instance, you are treated as materially participating if you're involved in the activity for more than 500 hours during the year; your participation accounts for virtually all of the participation of anyone involved in the activity for the tax year; or if you participated in the activity for more than 100 hours during the tax year and participated at least as much as any other person (including those who don't own any interest in the activity) for the year.

The rules for real estate professionals are even more stringent. Typically, to qualify as materially participating you have to log more than 750 hours.

If it's a close call, put in the extra time to qualify as an active investor. It may help you avoid the 3.8% surtax. ●

Which Type Of IRA Do You Prefer?

There are two basic types of IRAs for retirement savers: the traditional IRA that has been around for decades and the Roth IRA, a more recent innovation. Each has pros and cons, so the choice often depends on your circumstances. To help you decide, here's a brief comparison.

First, be aware that both IRAs share some common traits. The contribution limit for 2013 for all IRAs (of either type) is $5,500 (up from $5,000 in 2012). If you're age 50 or older, you can kick in an extra $1,000. There's no current tax on earnings from contributions within either IRA. And the deadline for contributions is the tax return due date for the year of the contribution, with no extensions permitted.

Now let's examine the key differences.

1. Traditional IRAs. If your modified adjusted gross income (MAGI) exceeds a specified annual level *and* you actively participate in an employer retirement plan, the deductibility of your contributions will be phased out. The phaseout for 2013 occurs for a MAGI between $59,000 and $69,000 for single filers, and between $95,000 and $115,000 for joint filers. If your spouse participates in an employer plan but you don't, the phase-out range is between $178,000 and $188,000 of MAGI. Thus, many high-income individuals can't deduct any part of their contributions.

When you take distributions during retirement, you're taxed at ordinary income rates on the portion representing deductible contributions and earnings. Furthermore, if you're under age 59½ when you take a distribution, you must pay a 10% tax penalty (unless one of several exceptions applies).

2. Roth IRAs. Unlike with a traditional IRA, contributions to a Roth are never deductible, regardless of your MAGI. In addition, the ability

The Bypass Trust: It's Not Dead Quite Yet

To paraphrase Mark Twain, reports of the death of the bypass trust are greatly exaggerated.

The bypass trust, also often referred to as a "credit shelter trust," has long been a popular estate-planning vehicle. As the name implies, this type of trust is established so funds bypass your spouse's estate on their way to your children. Because the trust effectively can use the full estate tax exemption for each spouse, it enables a married couple to transfer millions without paying a dime in federal estate taxes.

Typically, to create a bypass trust, each spouse might include a provision in his or her will that sets up a trust for the surviving spouse's benefit, and is funded with the equivalent of the deceased spouse's unified credit exemption amount (up to $5.25 million in 2013). Then, when the surviving spouse dies, the remaining assets go to the kids. If the trust is structured properly, this arrangement may avoid estate tax by utilizing the estate tax exemptions of both spouses.

A new tax law dramatically changes the landscape but the bypass trust remains viable. Under the American Taxpayer Relief Act of 2012 (ATRA), several generous estate and gift tax provisions are extended permanently, with a few modifications. Among those are provisions that may seem to signal the demise of the bypass trust, but that's not necessarily the case.

After the estate tax exemption was increased gradually from $1 million in 2001 to $3.5 million in 2009—while the top estate tax rate decreased from 55% to 45% —the estate tax was completely repealed for one year, in 2010. The 2010 Tax Relief Act reinstated the estate tax in 2011 with an exemption of $5 million (indexed for inflation) and a top rate of 35% for two years, through 2012. Significantly, the 2010 act also allowed "portability" of exemptions, with any portion of an exemption not used by the first spouse to die to become available to the surviving spouse's estate. But these estate tax provisions were scheduled to expire after 2012, leaving the future of portability in doubt.

Beginning in 2013, ATRA permanently extended portability of federal estate exemptions between spouses while setting the individual exemption at $5 million (indexed to $5.25 million for 2013). In other words, a couple now can transfer more than $10 million to their heirs without estate taxes, no matter when they die or how they split up their assets. Do these changes make the bypass trust obsolete? Though the new rules change the tax landscape, there are still at least five good reasons why you might use such a trust:

1. State inheritance taxes. Remember that federal estate taxes are only part of the story. You still may have to contend with state estate taxes if you're leaving a substantial amount of assets to your heirs. For instance, if you reside in a state that has "decoupled" from the federal estate tax—setting its own rules that don't necessarily align with federal laws—a bypass trust might help your heirs avoid or minimize state taxes.

2. Medicaid eligibility. Rules for qualifying for Medicaid—often, to pay for long-term care at a nursing home—consider personal assets. But assets that are transferred to a trust generally don't count for establishing Medicaid eligibility (though there is a five-year "look-back" rule that affects such transfers).

3. Extra-large estates. If a couple's total assets exceed the amount of their combined exemptions ($10.5 million in 2013), their heirs will owe federal estate taxes. However, if funds are transferred to a bypass trust, any appreciation in the value of assets in the estate of the first spouse to die won't be taxed.

4. Generation-skipping tax. A special generation-skipping tax (GST) is imposed on most transfers from grandparents to grandchildren (such transfers "skip" a generation). Although your estate benefits from a personal GST exemption equivalent to the federal estate tax exemption ($5.25 million in 2013), there's no portability of GST exemptions. So the old benefits of a bypass trust still apply for reducing a couple's exposure to the GST.

5. Spendthrift concerns. A trust may be preferable to giving funds outright to children who might squander them. Consider the non-tax benefits of using a bypass trust to bequeath assets to other family members.

Obviously, there's more to bypass trusts than first meets the eye. Don't write the obituary just yet. ●

to make full contributions to a Roth is phased out for 2013 for a MAGI between $122,000 and $127,000 for single filers, and between $178,000 and $188,000 for joint filers.

However, qualified distributions from a Roth in existence for at least five years are 100% tax-free. This includes distributions made (1) after age 59½, (2) due to death or disability, or (3) used to pay qualified first-time homebuyer expenses (lifetime limit of $10,000). Other distributions are taxed at ordinary income rates under "ordering rules," which treat contributions as coming out first, then conversion and rollover amounts, and finally earnings. So a portion or all of a payout still may be tax-free.

Due to the back-end benefits, you might convert funds in a traditional IRA to a Roth, paying tax in the year of conversion. If it suits your purposes, you can "undo" the conversion by the tax return due date (including any extension).

Which type of IRA is best for you? Figure it out by factoring in all the variables. We can help you crunch the numbers. ●

Straight Talk About Living Trusts

Ask two financial experts about the benefits of using a revocable living trust and you might well get precisely opposite reactions, especially on a regional basis. One might say that it's the greatest thing since sliced bread, while the other could argue that it should be avoided like the plague. The truth probably lies somewhere in between.

How does a living trust work? You set up the trust, transfer assets to it, and name a trustee to handle matters. If you designate yourself as the "initial beneficiary," you're entitled to receive income from the trust for the rest of your life. At the same time, you designate "secondary beneficiaries"—perhaps your spouse, your children, or both spouse and kids—who will receive the remaining assets when the trust terminates.

Significantly, you can still retain some control of assets in a living trust while you're alive. For instance, depending on the trust terms, you may be able to sell assets and keep the proceeds, amend terms of the trust (for example, change secondary beneficiaries), or revoke it entirely. The assets in the trust become irrevocable upon your death.

The main advantage is that assets in a living trust are exempt from probate, a process that may be required for assets bequeathed through a will. Proponents of living trusts note that the probate process can be costly and time-consuming. Also, if you face physical or mental limitations in your old age, with a living trust, a trustee for your assets is already in place.

However, detractors point out there are less expensive ways of avoiding probate, such as acquiring property jointly with rights of survivorship (although this may not be the best option in community property states). Also, the cost and complexity of probate is often exaggerated and can vary greatly from state to state. Finally, despite a common perception to the contrary, there's no estate tax advantage to using a living trust if you retain the right to revoke it, as is typically provided. And even die-hard supporters of living trusts acknowledge you'll still need a will to tie up the loose ends of your estate.

So when does a living trust make sense? Consider these four key factors:

1. Age. Younger people in good health have less incentive to use a living trust than do retirees. Remember, a living trust will provide little benefit during your life.

2. Financial status. The more wealth you have, the more you're likely to benefit from a living trust. It will make things easier on your heirs if some or all of your assets bypass probate.

3. Marital status. If you're married and you own a house or other main assets jointly with your spouse, there's less need for a living trust. Furthermore, many states allow surviving spouses to use expedited probate procedures.

4. Confidentiality. One of the main arguments for a living trust is that your testamentary disposition remains confidential. This could be important for some families.

Don't be swayed by the hype of either point of view. Make an assessment of whether a living trust is right for you. ●

13 Midyear Tax Planning

(Continued from page 1)

distributions won't be taxed. To avoid absorbing a big income-tax hit—due on money you transfer—all at once you could spread out conversions over several years.

8. Transfer IRA funds to charity. For 2013, someone age 70½ or over can withdraw up to $100,000 from an IRA and give it directly to charity without any tax consequences. This tax break, which had expired recently, now has been extended through the end of 2013.

9. Sell the old homestead. The tax law allows you to exclude tax on a gain of up to $250,000 for single filers and $500,000 for joint filers if you've owned and used the home as your principal residence at least two of the past five years. The excluded amount is exempt from the 3.8% surtax.

10. Rent out a vacation home. You can write off certain rental activity costs, plus depreciation, but you must be careful. If your personal use exceeds the greater of 14 days or 10% of the days the home is rented out, deductions are limited to the amount of rental income. Keep summertime personal use below the threshold.

11. Give grads generous gifts. Generally, you can claim a $3,900 dependency exemption for a child graduating from college in 2013 if you provide more than half of the child's support. Figure out the amount of a gift needed to put you over the half-support mark.

12. Install energy-saving devices. The tax credit for energy-saving improvements in a home—such as central air conditioning—is restored for 2013. But the maximum credit of $500 is reduced by expenses claimed in prior years.

13. Adjust your withholding. Finally, due to all the tax-law changes in 2013, you may not be withholding enough income tax from your paychecks. Make the adjustments needed to avoid an "estimated tax penalty" this year. ●

John R. Day CPA/PFS **Bill Ennis CPA/PFS** **125 Plantation Centre Dr., Bldg. 400 Macon, GA 31210**
(478) 474-7480 **www.dayandennis.com**