The
FINANCIAL UPDATE

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FEE-ONLY FINANCIAL PLANNING

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Don't Be Blindsided By The New Medicare Surtax

Are you in the top tax bracket in 2012? Currently, the highest earners are required to pay tax at a rate of 35% on ordinary income such as salary and short-term capital gains. Once you reach the top bracket, every additional dollar of ordinary income you earn this year will be taxed at the 35% rate. Add in state and local taxes and you could end up losing a substantial chunk of what you've earned.

But this situation will get considerably worse if Congress doesn't act before the end of the year. In addition to higher federal income tax rates that are scheduled to take effect in 2013, there will be a brand-new tax on investment income: the so-called Medicare surtax. This new provision was included in the massive health care law enacted in 2010.

The new Medicare tax is unlike virtually any other tax provision on the books. There's already a Medicare payroll tax, but it applies only to earned income, such as wages, whereas the new levy hits money from your investments. However, with some advance planning, you may be able to reduce the tax impact next year, or even avoid the new tax altogether.

Under the new rules, the 3.8% 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).

For this purpose, "net investment income" includes interest, dividends, royalties, rents, gains from dispositions of property, and income from passive activities. But tax-free interest payments from municipal bonds and distributions from 401(k)s, IRAs, and other retirement plans are excluded. In effect, the new rules mean that if your MAGI exceeds the income threshold, your investment income up to the amount of excess MAGI will be subject to the surtax.

Suppose you are a single filer, your MAGI in 2013 is $350,000, and you have $100,000 in net investment income. Because your investment income is less than the amount by which your MAGI exceeds the $200,000 threshold, you owe the 3.8% Medicare tax on the $100,000 of net investment income, which adds $3,800 (3.8% of $100,000) to your tax bill.

If you think you're in danger of triggering the 3.8% Medicare tax next year, start planning now to minimize the tax damage. These ideas might help.

- Sell some of your highly appreciated assets before the end of the year. As an added incentive to take profits now rather than later, this year's maximum 15% tax rate on long-term capital gain will increase to 20% in 2013, barring any last-minute extension of the current rates. Assuming it makes sense from an investment standpoint, pull the trigger in 2012.
- Increase your portfolio exposure

(Continued on page 4)

Updated Website And New Blog

We have recently updated our website and invite each of you to visit the site at www.dayandennis.com. The site includes the usual background information on the firm and our team, plus copies of our newsletter, calculators, and our new blog.

The blog is called **Mid-Week with Day & Ennis** and will be updated each Wednesday. The purpose of this blog is to summarize articles that we have read in the prior week to keep us informed on the economy, investment markets and financial planning issues. We will summarize the articles and if you are interested in reading the entire article, there will be a link to the article. A few of the sources will include John Mauldin, Bill Gross with PIMCO, graphs and charts from the website of Doug Short, updates from the Economic Cycle Research Institute (ECRI), Jeremy Grantham, Howard Marks, and others. If you are interested in receiving a weekly email with updates to **Mid-Week with Day & Ennis**, you can subscribe on the website.

John R Day Bill Ennis

What Are The 401(k) Limits In 2012?

The 401(k) plan continues to be, by far, the most popular company-sponsored retirement plan in the land. And it's no wonder. This unique retirement-saving vehicle offers tax advantages to employees and can also be a valuable tool for employers looking to recruit and retain top talent.

The basic premise is simple: You arrange to have a portion of your pre-tax salary deposited in a separate account. Frequently, an employer will agree to match each dollar that plan participants contribute, up to a specified percentage of compensation. For example, if you earn $100,000 and put $10,000 a year into your 401(k), your company, providing a 3% match, would kick in another $3,000 annually.

There's no current tax on investment earnings within the account, though you also don't get to claim a deduction for losses. Distributions from the account, usually during retirement, are taxed at ordinary income rates. If you change jobs or retire, you normally can choose among keeping the money in your old company's plan, shifting it to a new 401(k), or rolling over some or all of the account to an IRA.

That's the short story. But there are numerous other legal limits and restrictions to contend with. One of the biggest is the annual limit on how much salary you can defer, a number that rises based on an inflation index. Furthermore, the plan must satisfy strict, complex nondiscrimination requirements.

How well do you know the current rules? See how you fare on this brief quiz.

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1) The maximum amount an employed 45-year-old can contribute to a 401(k) in 2012 is:

a) Zero.
b) $17,000.
c) $21,500.
d) $22,500.

2) The maximum amount an employed 55-year-old can contribute to a 401(k) in 2012 is:

a) Zero.
b) $17,000.
c) $21,500.
d) $22,500

3) The maximum amount a retired 65-year-old can contribute to a 401(k) in 2012 is:

a) Zero.
b) $17,000.
c) $21,500.
d) $22,500.

4) The minimum number of employees required to establish a 401(k) plan is:

a) 1. c) 25.
b) 10. d) 100.

5) If you aren't a company's owner, you must begin taking distributions from its 401(k) plan:

a) At age 59½.
b) At age 70½.
c) When you retire.
d) At age 70½ or your retirement date, whichever comes later.

6) A rollover from a 401(k) plan to an IRA is subject to a 20% withholding tax unless:

a) You complete the rollover within 60 days.
b) You arrange a trustee-to-trustee transfer.
c) You retire before the end of the tax year.
d) You are under age 59½.

7) If you receive a $10,000 "hardship distribution" from a 401(k) in 2012 and you're in the 25% tax bracket, your income tax liability is:

a) Zero. c) $2,500.
b) $1,000. d) $3,500.

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

Start Harvesting Gains In 2012

If you're in the same tax boat as most other investors, you should start thinking about harvesting capital gains from securities sales in 2012.

That's right—harvesting gains, not losses. The normal advice is to look for valuable tax losses, especially at the end of the year, that you can use to offset capital gains as well as up to $3,000 of ordinary income. (You can carry over excess losses to the following year.)

But this year is different. The current maximum tax rate of 15% on long-term capital gains—realized on the sale of securities you've held longer than a year—is scheduled to increase to 20% in 2013. Furthermore, the tax rate for short-term gains (from the sale of assets held one year or less) will also rise, especially for high-income investors. Short-term gains are taxed at ordinary income rates that currently reach no higher than 35%. Beginning in 2013, however, the top rate for ordinary income is set to rise to 39.6%. Next year you may also be subject to a 3.8% Medicare surtax that will apply to net investment income if you exceed a specified threshold.

Congress could still act to preserve some or all of the lower tax rates, but even if that happens, it probably won't be until after the November elections. Therefore, the optimal approach, at least for now, is to focus on the current tax benefits of selling stocks that have appreciated significantly during the time you've owned them. If you believe those shares are likely to continue to increase in value, it probably makes sense to hold on to them and not to worry about future tax consequences. But if the outlook for future gains is uncertain, you might want to take advantage of today's favorable tax treatment of long-term capital gains.

Let's suppose, hypothetically, that you're holding a stock position you

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. ●

bought 10 years ago for $10,000 that is now worth $25,000. If you sell the stock in 2012 and have no other capital gains or losses during the year, you'll pay tax of $2,250 (15% of your $15,000 profit). But if you wait until next year to sell at the same $25,000 price, you'll owe tax of $3,000 (20% of the $15,000 profit). That's an extra $750 in tax you could avoid.

Tax planning that involves investing decisions can quickly become complicated, and it's always important not to let the "tax tail wag the investment dog"—that is, to put tax considerations before sound investment strategies. That's why this year, in particular, it's wise to start considering the possibilities long before year-end deadlines and to consult with your tax and investment advisors. We can help you stay on top of possible changes to the tax laws and work with you to make choices that are right for your situation. ●

Six Disability Facts To Consider

You probably already understand the importance of having life insurance. The proceeds from a life policy can help cover your family's current expenses and may provide a cushion for the future if you die prematurely. But another kind of coverage—disability income (DI) insurance—is often ignored or neglected. And that's a mistake, because DI insurance can be even more vital than life insurance in maintaining a family's financial well-being. A new white paper from the Council for Disability Awareness, an independent nonprofit group, provides these six startling facts.

1. More than one in four of today's 20-year-olds will become disabled before they retire. (Source: Social Security Administration, Fact Sheet, March 18, 2011)

2. Some 8.5 million disabled U.S. wage earners were receiving Social Security Disability Insurance (SSDI) benefits at the end of September 2011. (Source: Social Security Administration, Office of Disability and Income Security Programs)

3. Ninety percent of new long-term disability claims are the result of an illness, not an accident, and fewer than 5% of claims are work-related. (Source: 2011 Council for Disability Awareness Long-Term Disability Claims Study)

4. The average long-term disability claim lasts 31.2 months. (Source: 2010 GenRe Disability Fact Book)

5. New applications for Social Security Disability Insurance (SSDI) benefits increased 27% from 2008 to 2010. (Source: Social Security Administration, Office of Disability and Income Security Programs)

6. About 100 million workers lack private disability income insurance. (Source: Social Security Administration, Fact Sheet, March 18, 2011)

If you don't have DI insurance, either through a policy from your employer or one you've bought on your own, you can choose from among a wide array of products whose costs and benefits vary widely. Here are several factors you'll need to take into account.

- How a policy defines "disability" is crucial. The best policies pay benefits if you can't work in your chosen profession, and they don't consider the nature of an injury.
- DI insurance policies generally require a waiting period before paying benefits, and a shorter waiting period normally translates into higher premiums.
- Typically, a policy will state how long and under what circumstances it will pay disability income benefits. It could, for example, provide benefits only until you qualify to receive Social Security retirement benefits.
- If you opt for a noncancellable policy, the insurer can't drop you off its rolls if your health declines.

Finally, don't be seduced by the low costs of a fly-by-night operation. You'll be better off opting for an experienced company with a good reputation. ●

Don't Be Blindsided

(Continued from page 1)

to municipal bonds. Interest from tax-exempt obligations doesn't count as investment income for the purposes of the new surtax. Be aware that muni offerings may become scarce at the end of the year, so start hunting now.

- Bulk up your 401(k). Like interest from munis, distributions from 401(k)s and other retirement plans aren't included in calculating your net investment income. So the more you can sock away in your 401(k) account, within the generous tax law limits, the more you can shelter from the Medicare tax. Contributing more now also reduces your taxable income for 2012 and helps you accumulate funds for retirement.
- Convert a traditional IRA to a Roth IRA. Future qualified distributions from a Roth will be 100% tax-free. So it may be worthwhile to absorb the tax hit on a conversion this year (especially because tax rates are scheduled to increase next year).

- If you're contemplating the sale of a business in which you hold a passive ownership interest, do it before 2013. The amount of your net investment income includes passive activity interest.
- If you plan on selling your home soon, try to complete the sale before 2013. Generally, joint filers can exclude tax on the first $500,000 of gain from the sale of a principal residence ($250,000 for single filers), if certain requirements are met. But the 3.8% Medicare tax will apply to any portion of the gain that doesn't qualify under this home sale exclusion.

As things stand now, the top tax rate on ordinary income will increase to 39.6% in 2013. When you tack on the 3.8% Medicare tax, your effective tax rate on investment income could be as high as 43.4%. Don't stand by idly until the Medicare tax suddenly kicks in. Meet with your professional advisors to address your situation. ●

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