Your Taxes and the Fiscal Cliff ©

American Association of Individual Investors

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Income Taxes

Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands: Taxes are enforced exactions, not voluntary contributions.

-- Learned Hand, US Appeals Court Judge

Income Tax Rates

History has been clear that when individual tax rates are lowered or tax rates on dividends or capital gains are lowered, the next few years' tax receipts go up, not down.

Presidents Ronald Reagan, George W. Bush, Bill Clinton and John F. Kennedy all lowered tax rates or capital gains and dividends rates and more tax revenues, not less revenues, were received.

Irony

In the last four years, the Federal government’s Food Stamp program enrollment has risen from 31 million to 47 million Americans.

The US National Park Service warns:

"Please Do Not Feed the Animals.“

Their stated reason for the policy: "The animals will grow dependent on handouts and will not learn to take care of themselves."

Unintended Consequences

Any item of income or loss can affect taxes on other income.

The tax code is complex, sneaky, illogical & unfair !

Higher income can:

- Put you into a higher tax bracket
- Reduce your Itemized Deductions
- Reduce Personal Exemptions
- Phase-out deductions for residential rental losses
- Can make you subject to AMT
- Social Security can go from 0% taxable to 50% or 85% taxable
- Medicare premiums can go up dramatically
- Obamacare tax can kick in on your investment income

Strategies:

- Defer recognition of taxable income
- Spread income over more than one year
- Convert taxable income to tax-deferred income or tax-free income

Some Definitions

- Total Income
- Deductions – “above the line”
  - IRA contributions
  - Certain college education and health care expenses
  - Alimony
- Adjusted Gross Income (AGI)
- Deductions – “below the line”
  - Standard Deduction or
  - Itemized Deductions
- Personal Exemptions
- Taxable Income
- Credits
  - Directly reduces the tax due
  - Non-refundable
  - Refundable
  - Withholding and estimated tax payments
- Tax Due or Refund

“Taxpayer Relief Act of 2012”
(Actually passed in 2013)

Highlights

- The lower “Bush Tax Cut” rates are made permanent, except for:
  - “High earners”, whose top rate increases from 35% to 39.6%
  - “High earners”: AGI $400,000+ single, $450,000+ MFJ
- The AMT exemption is made permanent and indexed for inflation
- Capital gains and qualified dividend rates remain at 15% for most taxpayers, except:
  - “High earners”, whose rate will increase to 20%
- The 2% payroll tax holiday is <u>not</u> extended, rate to 6.2% from 4.2%

Taxpayer Relief Act of 2012

Personal Exemptions: $3800 for 2012, $3900 for 2013

- Phase-out for "High earners" begins:
- AGI $250,000 single, $300,000 MFJ
- Phase-out: 2% for each $2500 over AGI limit

Standard Deduction:

- Single: $11,900 for 2012, $12,200 for 2013
- MFJ: $5,950 for 2012, $6,100 for 2013
- Phase-out for "High earners" begins:
- AGI $250,000 single, $300,000 MFJ
- Phase-out: 3% of excess AGI, not more than 80% phased out

Obamacare Taxes

Itemized Deduction disallowance:

- Medical Itemized Deduction disallowance
- 2012 and before: 7.5%
- 2013 and after: 10%
  - If 65+ then 7.5% still applies – until 2017

New investment tax

- 3.8% rate on top of capital gains & dividends tax
- Applies to AGI $200,000+ single, $250,000+ MFJ

Medicare Payroll Tax increase

- 2012 and before: 1.45%
- 2013 and after: 2.35%
- Applies to AGI $200,000+ single, MJF $250,000+ MFJ

Flexible Spending Accounts 2013

- New cap on amounts contributed: $2500

10% excise tax on indoor tanning services

2.3% excise tax on medical devices sold to hospitals, clinics, etc.

Taxpayer Relief Act of 2012

Alternative Minimum Tax (AMT)

- AMT created in 1969 to “catch” a few persons that were paying no federal income taxes
- A separate tax system with its own rules
- Over time, due to no indexing the number of taxpayers affected has risen from about a dozen to about 33 million
- Most years there has been a temporary “fix”: raise the exemption

New Act finally fixes AMT exemption

- 2012 exemptions: $50,600 single, $78,750 MFJ
- Permanent and inflation adjusted !

Taxpayer Relief Act of 2012
Miscellaneous

IRA-to-charity exclusion

- Expired after 2011, has been revived for 2012 and 2013
- Because of late passage, the Act provides two special rules:
  - You may make a charitable distribution in January 2013 and it is deemed to have been made in 2012
  - Any portion of a distribution from an IRA in December 2012 may be treated as a qualified charitable distribution to the extent that the distribution is transferred to a qualifying charity before February 1, 2013

Reinstated previously expired provisions for 2012 and 2013

- The $250 maximum deduction for educator expenses
- Exclusion from gross income of discharge of qualified principal residence indebtedness
- The enhanced exclusion from income for employer-provided mass transit and parking benefits

Taxpayer Relief Act of 2012
Miscellaneous - continued

Reinstated previously expired provisions for 2012 and 2013

- Mortgage insurance premiums treated as qualified residence interest
- Deduction of state and local general sales taxes
- Special rule for contributions of capital gain real property made for conservation purposes
- Above-the-line deduction for qualified tuition and related expenses

Reinstates for 5 years credits that had expired at the end of 2012

- The American Opportunity Tax Credit for qualified tuition and other expenses of higher education
- The reduced earnings threshold for the refundability of the child tax credit
- • Enhanced provisions of the earned income tax credit

Future Tax Targets

Year 2012: Forms W-2

- Employers required to print "value" of company medical plan benefit
- "For information purposes only"
- More and more statements from the White House and Congress that employer medical plans are the biggest remaining tax "loophole"….
- No mention of Presidential or Congressional medical plans*

Another "loophole" mentioned frequently:

- Home mortgage interest deduction

* Don't tax you, don't tax me, tax that fellow behind the tree.

-- Russell Long, former Senate Finance Chairman

“The Rich”, “The High Earners”, and “The Middle Class”

Trend of politicians using class warfare to promote tax increases: saying that a tax increase will only affect the “Rich” and “protect” the “Middle Class”

- Social Security taxation
  - Original program design: after-tax in, after-tax out
  - 1984: increased taxation from 0% to 50%
  - 1994: increased taxation from 50% to 85%
    - Begins at Single: $25,000 MAGI, Married: $32,000 MAGI

- Medicare surcharge
  - Threshold: Single & MFS: $85,000 MAGI, MFJ: $170,000
  - Additional Part B premium $42-$230 /mo. ($504-$2770 annual)
  - Additional Prescription premium $11-$76 /mo. ($139-$800 annual)

“The Rich”, “The High Earners”, and “The Middle Class”

Obamacare taxes

- AGI Thresholds: Single: $200,000+, MFJ: $250,000+, MFS: $125,000+
  - Additional tax on investments: 3.8%
  - Additional Medicare tax on wages and self-employment: .9%

Tax Relief Act of 2012

- Capital Gain & Dividends thresholds: Single: $400,000, MFJ: $450,000
- Personal Exemption & Itemized Deduction phase-outs
  - Single: $250,000;   MFJ: $300,000;   MFS: $150,000

“The Rich”, “The High Earners”, and “The Middle Class”

Rental real estate losses can’t be deducted

- Single or Married: $100,000 - $150,000 AGI phase out

Traditional IRAs: can<u>not</u> deduct contribution if in a pension plan

- Single: $58,000 - $68,000 MAGI
- Married joint: $92,000 - $112,000 MAGI
- Married separate: $10,000 MAGI

Roth IRAs: can<u>not</u> make contribution

- Single: $125,000 (phase-out begins at $110,001)
- MFJ: $183,000 (phase-out begins at $173,001)

"The Rich", "The High Earners", and "The Middle Class"

Married Couple – Both with careers

- Technical – Professionals
- Is a $125,000 annual salary each "rich" ?

Long time homeowners

- Gain of sale of personal residence
  - Single exemption: $250,000
  - MFJ exemption: $500,000
  - Any excess adds to other income for all purposes including Soc. Sec. and Medicare premiums

Widow / Widower selling their home

- Unless personal residence is sold in year of death of spouse or following year: $250,000 exemption applies

Do you own a rental house or other real estate?

- <u>All</u> gains added to regular income for all purposes

Medicare Part B Premium Surcharge

- 2013 premium based on 2011 MAGI (AGI plus “tax-exempt” income)
- Medicare monthly premiums for 2012:

Single Taxpayer:	Married Taxpayer:	Mo. Premium:
MAGI under $85,001	MAGI under $170,001	$ 104.90
$ 85,001- $107,000	$ 170,001-214,000	$ 146.90
$ 107,001- $160,000	$ 214,001-$320,000	$ 209.80
$ 160,001- $214,000	$ 320,001-$428,000	$ 272.70
$ 214,000+	$ 428,000+	$ 335.70

- You can appeal surcharge if “Life Changing Event”
  - Marriage, Divorce, Death of Spouse, Stopping Work
  - Involuntary loss of income (natural disaster, insolvent pension)
  - High income due to sale of property is not a LCE

Estate Taxes

Pre-2010

- Exemptions ranged from $600,000 - $3,500,000
- Estate tax rate up to 55%
- Basis of assets received by inheritance
  - Fair market value on date of death

Estate Tax Changes
Tax Relief Act of 2010

2011 -2012

- $5 million exemption
- Married couple: $10,000,000 exemption available
  - Pre-2010 wills and trusts may be out-of-date and self-defeating
  - Most A-B trusts were designed with lower limit assumptions
    - May result no money transferring to surviving spouse
    - All money might go to irrevocable trust for children
    - You need to review your will and trust with an attorney
- Up to 35% estate tax rate on amounts over exemption
- Unused exemption upon death of first spouse can be carried over to estate of surviving spouse
- Basis of assets received by inheritance:
  - Fair market value on date of death
- Sale of Principal Residence:
  - Estate can get a separate $250,000 gain exclusion under §121

Estate Tax Changes
Tax Relief Act of 2012

2013 & after

- $5 million exemption
  - Adjusted annually for inflation !
  - 2013 projected amount is $5,250,000
  - Unlimited transfer amounts to surviving spouse
  - Unused deceased spouse's exemption goes to survivor
    - $5,250,000 x 2 = $10,500,000
- Maximum 40% estate tax rate
- California does <u>not</u> have an estate or gift tax
  - Don't tell Jerry Brown !

Gifts and Gift Taxes

2011 - 2013

Annual exclusion: $13,000

- $13,000 allowed per recipient
- Husband & wife can give $26,000 to one person
- Does <u>not</u> count against lifetime exclusion amount
- Does <u>not</u> require a gift tax return
- If annual gift over $13,000: a gift tax return (Form 706) <u>is required</u>
- IRS has a current campaign to find gifts over $13,000
- IRS is making inquiries to State of California about real estate transfers to family members

Lifetime exclusion: $5 million ($5.25 million in 2013)

- Married couple can exclude up to $10.5 million
- Gifts over $13,000 count against lifetime exclusion

Where to Hold Your Investments

Taxable Accounts (if AGI under $400,000 - $450,000)

- Stocks, Mutual Funds, ETFs
  - LT Capital Gains receive 0-15% tax rate
  - Qualified Dividends receive 0-15% tax rate
  - Capital Losses can offset other income
  - If these investments are in an IRA: ordinary tax rates (up to 35%)
- Tax-free Municipal Bonds
  - Can avoid both Federal and California income taxation
  - Private activity bonds are subject to AMT

Tax-deferred Accounts: Traditional IRAs, 401(k)s, Annuities

- Bonds, Money Markets, CDs, ETNs
  - Earnings within these accounts are tax-deferred
  - Put your “income” (interest) investment allocation here
  - Upon withdrawal, all income is taxed at ordinary tax rates (up to 35%)

Tax-free Accounts (Roth IRAs)

- No income tax consequences (usually)
- Focus only on maximum investment return

IRAs: Traditional vs. Roth

Traditional IRA

- Investment gains are <u>tax-deferred</u>
- Withdrawals are <u>taxed</u> at ordinary income tax rates
- RMDs after age 70½
- Withdrawals by beneficiary are <u>taxed</u> at ordinary income tax rates
- IRA balance at death is subject to estate taxes

Roth IRA

- Investment gains are <u>tax-free</u>
- Withdrawals are <u>tax-free</u>
- <u>No</u> age 70½ RMDs
- Withdrawals by beneficiary are <u>tax-free</u>
- IRA balance at death is subject to estate taxes
- Each dollar in a Roth IRA is more valuable than a dollar in a traditional IRA

Reasons to Convert to a Roth IRA

1. Avoids RMDs after age 70 ½
2. If you have a special tax situation
   - Low year of income
   - Business Losses
   - Tax credits
   - Suspended real estate rental losses
   - High Charitable Contributions (current or carry-overs)
3. If you have non-deductible contributions in your IRA
   - They are <u>not</u> taxable at conversion
4. Have non-IRA funds available to pay income tax on conversion
5. If you think income tax rates will rise in the future

Reasons to Convert to a Roth IRA (continued)

6. Exposure to AMT can be reduced in future years
7. Avoiding higher income taxes after one spouse dies
   - Married joint tax rates are lower than single rates
   - Pay tax now at lower rates married joint rate
8. Large estates: pay income taxes now, reduces estate
   - After-tax value of traditional IRA = total value of Roth IRA
9. Time is on the side of Roth IRAs (tax-free compounding of returns)
   - Your lifetime
   - Spouse's lifetime
   - Children's lifetime

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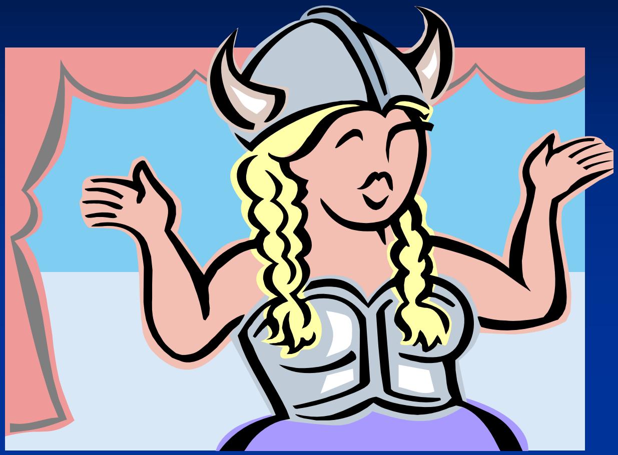

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