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New Law Poses Tax Risks For High-Income Investors

It will take time for investors to absorb exactly what happened—and what did *not* happen—in the new tax law enacted to avert the "fiscal cliff." Under the new law, called the American Taxpayer Relief Act (ATRA), favorable tax rates on different types of investment income generally were preserved, but certain upper-income investors will face tax increases, beginning in 2013.

When you combine the ATRA changes with the new 3.8% Medicare surtax—also making its debut in 2013—you could be hit with a rate as high as 43.4% on a portion of your investment income.

Consider the following three main new tax law provisions:

1. Ordinary income. The existing federal income tax rate structure—with rates of 10%, 15%, 25%, 28%, 33%, and 35%—continues for most taxpayers. But ATRA adds a new top tax of 39.6% for single filers with income of more than $400,000 and joint filers with income above $450,000. That means that a short-term capital gain on the sale of a stock you've owned for a year or less—a profit taxed at ordinary income rates—could trigger the 39.6% federal rate.

2. Capital gains and qualified dividends. Under ATRA, the maximum tax rate for net long-term capital gains and qualified dividends remains 15% (0% for investors in the lowest tax bracket). If the law hadn't passed, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket), and dividends were scheduled to be taxed at ordinary income rates. Despite the reprieve for most investors, however, those who exceed those same high-income thresholds—$400,000 for single filers and $450,000 for joint filers—now will pay a maximum 20% tax rate on long-term capital gains and qualified dividends.

3. Medicare surtax. This "add-on" tax actually was included in the 2010 health care legislation—the Patient Protection and Affordable Care Act—rather than ATRA. But it also takes effect in 2013, and it can be just as lethal to upper-income investors as some ATRA changes. A 3.8% Medicare surtax now will apply to the lesser of "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount—$200,000 for single filers and $250,000 for joint filers. These figures will not be indexed for inflation.

For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. Certain items are excluded from the NII definition, including wages, self-employment income, Social Security benefits,

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What's Driving Emerging Markets?

Emerging markets have outperformed the global economy historically. These are nations with business activities in the process of rapid growth and industrialization. They ended 2012 as global outperformers, only to lose their momentum in 2013.

China is the largest contributor to the underperformance of emerging markets as the country has had a significant slowdown in economic growth. This is followed by other "BRICKS" (Brazil, Russia, India, Korea and South Africa) countries that also have suffered from poor returns. In the first quarter of 2013, China's GDP was 7.7%, which was below its expected target of 8.0%.

Another, more long-term concern for emerging markets is the growth in overall credit outstanding. Both Brazil and China have seen increases in their government debt, while China also is facing a potential bubble as housing prices continue to increase.

Long-term we think that emerging markets will turn around and still be a strong performer in our client's asset models. Although slowing, we believe China still will experience growth. Overall debt levels across emerging markets are not a worry as currency risks have been lessened. The underperformance of emerging markets has enhanced their valuations compared to developed market equities.

Roundup Of New Estate Tax Changes

For more than a decade, estate planning has harkened back to the "wild, wild west," a time when even the best hired guns didn't know what would happen next. Now, finally, there's more certainty, thanks to the estate tax provisions in the American Taxpayer Relief Act (ATRA). The new law, signed as the country teetered on the brink of the "fiscal cliff," extends several favorable tax breaks, with a few modifications.

Before we explore ATRA's main provisions, let's recap the events dating back to 2001, the year the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was enacted. Among the changes, EGTRRA gradually increased the federal estate tax exemption from $1 million to $3.5 million in 2009 while decreasing the top estate tax rate from 55% to 45%. It also severed the unified estate and gift tax systems, creating a lifetime gift exemption of $1 million unrelated to the estate tax exemption. Then the law repealed the estate tax completely, but just for 2010. After that year, the estate tax provisions were scheduled to "sunset," restoring more onerous rules that had been in effect before EGTRRA, unless new legislation dictated otherwise.

The Tax Relief Act of 2010 generally postponed the sunset for two years. It hiked the estate tax exemption to $5 million (indexed for inflation), lowered the top estate tax rate to 35%, and reunified the estate and gift tax systems. That law also allowed "portability" of exemptions between spouses.

Now, at long last, ATRA brings permanent clarity. Here are the key estate changes:

- The estate tax exemption remains at $5 million with inflation indexing. For 2013, the exemption is $5.25 million. Also, portability of exemptions between spouses is made permanent, so a married couple can effectively pass up to $10.5 million tax-free to their children or other non-spouse beneficiaries, even if the exemption of the first spouse to die isn't exhausted.
- The top estate tax rate is bumped up to 40%. Not as low as the 35% rate in 2011 and 2012, but still better than the 55% rate slated for 2013 prior to ATRA.
- The estate and gift tax systems remain reunified. This means that the lifetime gift tax exemption is equal to the estate tax exemption of $5.25 million in 2013. (That's now the maximum exemption for combined taxable lifetime gifts and estate bequests.) Other provisions, including the generation-skipping tax that applies to most bequests and gifts to grandchildren, are coordinated within the system.

As a result of these changes, now is a good time to examine wills, trusts, and other aspects of your estate plan. Depending on your situation, revisions may be required or you might create a new trust to take advantage of the current estate tax law. ●

Dust Off Life Insurance Policies

When was the last time you reviewed your life insurance policies? If you're like most people, you've probably stashed your policies in a drawer, filing cabinet, or safe deposit box where they've been gathering dust. But you should review your policies periodically to see whether they still meet your needs. Depending on the outcome, you might adjust your coverage.

In particular, you should examine your policy if you've experienced one or more major "life events" during the past year. What sort of events are we talking about?

- There may have been a birth, death, or disability in the family.
- You got married, divorced, or separated.
- You bought or sold a principal residence, vacation home, or other real estate property.
- Your child completed college or graduate school.
- You acquired property as a joint tenant.
- You have switched jobs, retired, or started up a new business.
- There was a significant economic change affecting your business operation.
- You need to revise the beneficiaries of your insurance policies due to a change in circumstances.

Note that other changes that might trigger a life insurance review could be less obvious. For instance, you may need additional coverage if you're now taking on financial responsibilities for an elderly or disabled relative. Conversely, your financial responsibilities may decrease somewhat if you have finished paying off a home.

Furthermore, you should try to view your family's needs as if you were buying life insurance for the first time. It's your current and future circumstances that are the critical factors—not how things were last year

Weigh The Key Factors For A Roth Conversion

Ever since the Roth IRA was introduced—way back in 1998—financial planners have been bombarded with questions about this retirement planning tool. Can I covert a traditional IRA to a Roth? If I can, should I? And if it is a good idea, when should I convert?

There's no blanket answer to all of those questions. To a great extent, the decision to convert or not will depend on your particular circumstances. Still, there are several key factors for you to weigh, and general guidelines based on the current tax landscape.

If you have a traditional IRA, all of the distributions you receive (to the extent that they represent deductible contributions and earnings) will be taxed at ordinary income rates. Beginning in 2013, the top tax rate on ordinary income was raised from 35% to 39.6%. In addition, a 3.8% Medicare surtax now applies to the lesser of your "net investment income" (NII) or the amount of your modified adjusted gross income (MAGI) that exceeds $200,000 for single filers and $250,000 for joint filers. Although IRA distributions don't count as NII for the surtax calculation, they can still boost your annual MAGI. As a result, you might pay an effective federal income tax rate of 43.4% on all or part of your IRA distributions.

In contrast, qualified distributions from a Roth IRA that you've had for at least five years are 100% tax-free. For these purposes, "qualified distributions" include those you take after you reach age 59½; because of death or disability; or that are used for first-time homebuyer expenses (up to a lifetime limit of $10,000). For instance, if you convert a traditional IRA with $1 million in assets to a Roth IRA at age 55, you can withdraw the entire $1 million, plus any earnings, at age 60 without paying a dime in additional federal income tax. (You will already have been taxed on the amount you converted to the Roth.)

Another important distinction is that you must begin taking required minimum distributions (RMDs) from a traditional IRA after reaching age 70½; in contrast, there are no mandatory lifetime RMDs with a Roth. This can be a crucial advantage if you won't need IRA funds in retirement.

It used to be that you couldn't convert to a Roth in a year in which your MAGI exceeded $100,000. But that barrier was removed in 2010, so conversions are now available to all retirement savers.

The main stumbling block is that a conversion is taxable at ordinary income rates just as if you had withdrawn the amount as a regular distribution. That means you need to examine at least four key factors in the conversion decision.

1. The tax rate differential. Compare your current tax rate with the tax rate bracket you expect to be in when you withdraw funds from your IRA in retirement. The lower your current rate as compared to the expected retirement rate, the greater the incentive to convert now. Conversely, you may not want to convert if your current rate is much higher than your expected rate during retirement.

2. Availability of non-IRA funds. One frequently overlooked Roth conversion question involves whether you have funds on hand to pay a significant conversion tax. If you'll be forced to siphon funds from your IRA to pay the tax bill, you're diluting the future benefit of a conversion. But a conversion now could make sense if you have money in other accounts to cover the resulting tax.

3. Funds you have to pay living expenses. Will you need to begin drawing down IRA funds within the next few years? If you have to tap a Roth right away, you may not realize the full benefit of the tax-free distributions. If you can keep your IRA intact for a longer period, a conversion may be more attractive.

4. Time horizon. A Roth conversion may appeal most to middle-aged investors who are still several years from retirement. If retirement is imminent or you're already retired, that may reduce your incentive to make a conversion. Nevertheless, switching to a Roth may still be reasonable if you're older, especially if you're looking for ways to preserve assets for your heirs.

Focusing on these four factors, crunch the numbers to see whether a Roth makes sense for your situation. One or more factors may count more heavily for you than others do, and we can help you do a detailed analysis.

Finally: Don't worry about pulling the trigger on a conversion and then regretting your decision. You can "recharacterize" a Roth IRA as a traditional IRA if you make the decision in advance of the tax return due date (plus extensions) for the year of the conversion. ●

or several years before. And don't forget to review all of your life insurance policies, including any group coverage that your employer (and your spouse's employer) might be providing.

Needless to say, this is an on-going process. A main function of life insurance is to replace lost income that your family relies on if you should die prematurely. When your financial obligations are small, the amount of life insurance coverage you require is also small. However, as those obligations grow, so does your need to acquire more coverage.

Typically, your life insurance needs will be at their greatest when your children are relatively young and you're in the midst of your career. Once your children have flown the coop, or you have retired, your insurance needs will likely not be as great.

Best approach: Assess your life insurance needs at regular intervals. You may want to do so at the start of a new year or on some other "anniversary" date. In any event, don't let too much time go by without a regular check-up. ●

Crash Course On Paying For College

There's good news in the mail: Johnnie or Susie just got accepted into a top college. Naturally, you're proud of your child. But now comes the hard part—figuring out how to pay for four years of education at an elite school.

Tuition costs at private institutions, in particular, can seem staggering. Still, there are ways to send your son or daughter to a great college without bankrupting your financial future. Start with these five steps:

1. Compare and contrast financial aid offers. There's no standard format for the wording of award offers, so carefully review the information in each one your child receives. Typically, the offers will list financial aid from several sources, including school scholarships, work-study programs, and federal loans, and also will note your "expected family contribution," calculated from the information you provide on the Free Application for Federal Student Aid (FAFSA). But some schools provide more information than others, so try to compare apples to apples.

2. Do the math. Once you determine how much aid each school will provide, figure out how much *you* will have to provide. Incorporate the amounts you expect your child will be able to cover—perhaps for such things as books, meals, and entertainment—into your calculations. That will give you a better handle on what you're really facing.

3. Expand the hunt for financial aid. Don't give up just because your child isn't a star athlete or a computer genius. You can find scholarships to fit a wide range of niches and groups on websites such as Fastweb.com, SchoolSoup.com, and SallieMae.com. In addition, students may qualify for state aid. Also, many corporations offer scholarships to children of employees. And remember to reach out to civic, religious, and ethnic groups within your community.

4. Consider a payment plan. Frequently, colleges provide tuition payment plans that charge little or no interest. You may have to pay just a small up-front fee. Contact the school for the necessary arrangements.

5. Explore loan options. If your family must borrow money, start with federal loans, which typically have the lowest interest rates. Currently, a subsidized federal Stafford Loan offers a fixed interest rate of 3.4%, while the federal PLUS loan features a 7.9% rate and Perkins loans have a fixed interest rate of 5%. Apply for these when you fill out the FAFSA. As a last resort, you might turn to private loans, but be aware that the interest rates on those tend to be higher.

This is just a quick lesson on navigating the financial aid waters. The schools your son or daughter is considering also may be able to provide ideas for reducing the financial burden on your family. ●

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tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans and IRAs.

Now let's see how these tax changes might affect taxes on investment income:

Example 1. You're a joint filer with an annual MAGI of $170,000 consisting mainly of wages. This puts you in the regular 28% tax bracket. At the end of the year, you realize short-term capital gains of $10,000 and long-term capital gains of $40,000, for a total of $50,000 in NII. Because you don't exceed the threshold for ordinary income, your short-term gains still are taxed at the 28% rate. And you don't exceed the threshold for capital gains either, so your long-term gains are taxed at the 15% rate. Finally, the lesser of your NII or excess MAGI is zero, so you don't have to pay the 3.8% Medicare surtax.

Example 2. You're a single filer with an annual MAGI of $500,000, consisting mainly of wages. This puts you in the new top tax bracket of 39.6%. At the end of the year, you realize short-term capital gains of $25,000 and long-term capital gains of $75,000, for a total of $100,000 in NII. Your short-term gains are taxed as ordinary income at the 39.6% rate. In addition, you exceed the threshold for capital gains, so your long-term gains are taxed at the 20% rate. Finally, the lesser of your NII or excess MAGI is $100,000, triggering a Medicare surtax of $3,800 on top of your other taxes.

Accordingly, the new tax rules could affect the rates you pay on investment income. And while taxes alone never should determine your investment decisions, it makes sense to factor them in when you're considering what and when to buy or sell. We can work with you to help you decide what makes sense in your situation. ●