

## 7 Major Tax Changes In The Fiscal Cliff Law

**F**rom the edge of the “fiscal cliff,” Congress took a step back and approved the American Taxpayer Relief Act (ATRA), a hodgepodge of tax extensions and modifications. But the agreement postponed decisions on spending cuts and failed to continue a 2% “payroll tax holiday” for employees. Moreover, upper-income taxpayers will have to shoulder a greater burden going forward. Here are seven noteworthy changes for individuals.



**1. Individual Tax Rates.** Across-the-board tax hikes are averted and the “marriage penalty” is eased. Nevertheless, ATRA creates an “extra” top tax rate of 39.6% for single-filers with income above \$400,000 and joint-filers with income above \$450,000. When you add in the new 3.8% Medicare surtax for certain upper-income investors, your effective top tax rate can reach 43.4% on some and possibly all of your net investment income.

**2. Capital Gains And Dividends.** The “Bush tax cuts” for capital gains and dividends are generally preserved. The maximum tax rate remains 15% for net long-term capital gain and qualified dividends (0% for investors in the lowest tax bracket). Otherwise, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket). Even worse, dividends would have been taxed at ordinary income rates. But investors in the highest tax bracket still pay a steep price: a maximum 20% tax applies to single-filers with income above \$400,000 and joint-filers with income of more than \$450,000.

**3. Alternative Minimum Tax.** The onerous alternative minimum tax (AMT), which has steadily been casting a wider net each year, is overhauled. Under ATRA, exemption amounts have been increased and nonrefundable personal credits can be used to offset AMT liability in full. In addition, the exemption amounts will be indexed for inflation in the future. Because the changes are

retroactive to the 2012 tax year, it’s been estimated they will save as many as 60 million taxpayers from the clutches of the AMT.

**4. Itemized Deductions And Personal Exemptions.** Two other “back-door” tax increases may affect taxes of wealthier individuals. Due to the revival of the “Pease rule,” most itemized deductions are reduced by 3% of the amount of adjusted gross income (AGI) above a specified threshold, beginning in 2013 (but the overall reduction can’t exceed 80%). At least ATRA establishes higher thresholds of \$250,000 for single-filers and \$300,000 for joint-filers. A comparable provision begins to phase out the tax benefits of personal exemptions at the same thresholds.

**5. Education Tax Breaks.** ATRA generally extends several valuable tax incentives relating to higher education. Significantly, it allows parents to claim the maximum \$2,500 American Opportunity Tax Credit (AOTC) for another five years, subject to a phaseout based on modified adjusted gross income (MAGI). It also extends the above-the-line deduction for tuition and fees, also phased out based on MAGI, through

## *In The Pursuit Of Happiness - Consider Philanthropic Giving*

**A**s our clients know, Financial Decisions makes charitable donations throughout the year, but you may not be aware we also donate our professional services to a few organizations in need of our investment advice and expertise. One organization we do this for is Girl Scouts Heart of the Hudson – an organization we’ve been thrilled to work with over the years and one that has honored us this year with their Humanitarian Award - thank you GSHH!

We are happy to help others through our philanthropic giving efforts – a feeling many experience. Study after study shows those who involve themselves in causes they care about, whether through financial donations or a donation of their time, reap lasting rewards through feelings of happiness. Philanthropic giving allows you the opportunity to express deeply held values and contribute to your community. And, nurturing a passion for charitable giving with your family members can bring your family closer as well as lay the groundwork for a long-lasting philanthropic legacy.

Our team has extensive experience incorporating philanthropic giving into our clients’ overall financial plans. If you have an interest in exploring your philanthropic passions, we’re here to help.

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# Some Simple And Effective Gifting Strategies

It may be better to give than to receive, but not if your giving results in a big bill for estate or gift taxes. Still, there are plenty of strategies for avoiding those levies. Making generous gifts now, while favorable rules are in effect, could be an especially effective way to transfer wealth to the next generation.

One approach to make tax-free gifts is by using the annual gift tax exclusion. Currently, this provision in the tax code lets you avoid taxation on gifts of up to \$14,000 to as many recipients as you choose. If your spouse joins you, the limit rises to \$28,000.

Suppose you have two adult children and three grandchildren. If you and your spouse make gifts of the maximum amount to each of those five people, together you can give away \$140,000 (5 x \$28,000), completely free of gift tax. And you can continue to provide that amount year in and year out without owing taxes on the transfers.

Meanwhile, you could also help family members by paying tuition or medical expenses on their behalf without tax liability. Those payments don't count against the annual exclusion as long as you pay the institutions directly.

By making a series of lifetime

gifts, you could remove substantial assets from your taxable estate, thus reducing potential estate tax liability for your heirs. There are also income tax benefits to this strategy if younger family members decide to sell the property gifted to them and they are in a lower tax bracket than you are. (One complication here is that investment income received by young children may trigger the "kiddie tax," with much of the income taxed at parents' rates. Even then,

however, making gifts to children is likely to result in a net tax benefit.)

To further sweeten the pot, current law enables you to transfer up to \$5 million of assets (indexed for inflation to \$5.25 million for 2013) to family members, either through gifts during your lifetime or through a bequest in your will. This \$5 million exemption, which is doubled to \$10 million for married couples

(indexed to \$10.5 million for 2013), was preserved by the American Taxpayer Relief Act (ATRA). Unlike many previous estate law changes, this extension under ATRA is permanent as long as the current law is in place.

There are, however, a few potential downsides to consider.

First, when you give away property, you no longer have control over it, and that could be a concern if you're putting money in the hands of those who may be too



young to handle it responsibly.

Moreover, you need to ensure you can afford any gifting you make and that you are not giving away money you could possibly need in the future.

Planning for how to best transfer money to children and grandchildren can be part of your overall financial strategy. We can work with you and your tax and legal advisors to find an approach that fits your situation. ●

## Beware Of Homeowner's Insurance Gaps

Disaster may strike your home when you least expect it. There could be damage from flooding, an earthquake, termites, or even mold—just to name a few possibilities. And though you probably assume repairs will be covered by your homeowner's insurance policy, they may not be. Your policy may exclude more events than you realize. Even when you are covered—for, say, flood damage—there may be "gaps" in your coverage that limit the amount you can recover.

The good news is that a typical homeowner's policy covers losses resulting from fires, tornadoes, and

severe storms. But the list of what it normally doesn't cover may surprise you. For instance, coverage may not extend to floods and earthquakes, although you can usually add a policy rider for such events. The rider's cost will vary based on whether you reside in a high-risk area.

Similarly, if you have to clean up a mess created by a water or sewage backup, the expense won't be covered by standard homeowner's insurance. But here, too, you can purchase a special rider to avoid this headache, often for less than \$100 a year.

The list of other types of damage that usually aren't covered range from

mold to insect and termite infestations to acts of terrorism, war, and nuclear attack. Dig your policy out of your files and take a few minutes to assess your risk exposure for these events.

Even if you're covered for damage—through standard insurance or a rider—payments from the insurance company are based on the property's replacement cost, not its fair market value. Also, if your home is destroyed and it's insured for less than the replacement value, you'll have to pay some of the rebuilding cost. In addition, deductibles and maximum dollar caps may affect reimbursements for possessions that are destroyed or stolen.

# Despite Pessimism, Slow Growth Persists

The Mideast is exploding in violence while Europe and China are in the throes of an economic slowdown. The top domestic story for months has been the U.S. fiscal cliff. Yet the fundamentals driving the economy remain fairly encouraging. Even with political leaders coming to an agreement on averting the fiscal cliff – a decision they had little choice but to do because the consequences would have been devastating — the economic recovery remains slow, but good enough to propel corporate earnings higher.

“This recovery is not fragile and it’s not risking stall-speed,” says Fritz Meyer, an independent economist. “We are three years into an economic recovery that has been persistent and steady. While it is subpar compared to

previous recoveries, it’s good enough to continue to drive higher corporate earnings, which is the key driver of stock prices.”

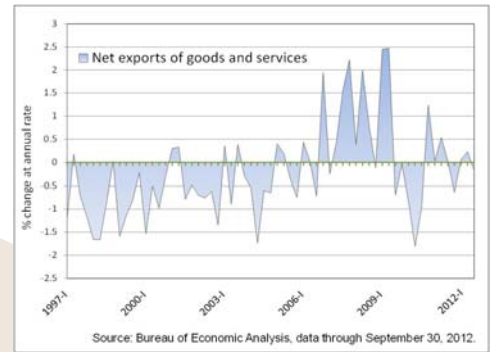
## Economic Growth Factors.

Economic growth is largely attributable to four key factors: consumption, investment, government spending, and net exports. When you examine these four components, the overall trend supports continued economic growth. The charts below show the respective contributions to GDP growth that each of these four factors have made since 1997.

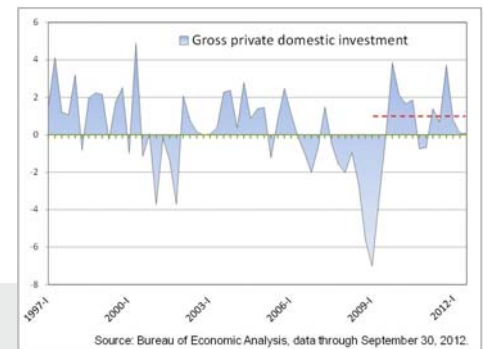
**Consumption.** The U.S. economy grew by about 2% in 3Q2012, and 1.5 percentage points of that growth came from consumption. The rate of growth in consumption in recent months was about one-half of 1% lower than the historical norm. However, consumption is holding up and is not too far off from its long-term historical rate.

## Government Spending.

Government spending surged in 3Q2012, largely from a jump in defense spending, a historically volatile category. Longer-term it’s hard to imagine that government spending won’t continue to grow more or less in line with the past, although in the near-term, state and local fiscal restraints will weigh on the aggregate government spending figures.

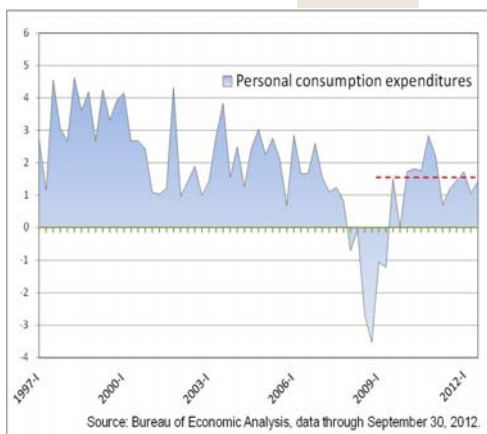


**Investment.** Gross private domestic investment includes construction—both residential and commercial — plus inventories held by corporations and other corporate spending. Here again, the picture does not portend a booming economy. But it’s untrue to say companies have not been investing. Yes, private investment stumbled in 3Q2012, but it has contributed just below 1% annually to the growth in the economy since the 2008 recession. Moreover, private investment fluctuates and an occasional dip amid a recovery is not unusual or alarming.



**Net Exports.** This key swing-factor in economic growth contracted in 3Q2012, but the subsequent release of third quarter trade figures suggests that net exports will be revised substantially higher, taking 3Q2012 growth closer to 3%, a good deal higher than the preliminary 2% that was reported. The substitution of domestic oil production for imported oil is a favorable development for the net exports contribution to GDP.

While pessimism abounds, the economic data shows an economy growing slowly and resulting in improved corporate earnings — a key driver of stock prices. ●



In terms of liability exposure, one way to avoid dire consequences is to supplement your current coverage with an umbrella liability policy. As the name implies, the umbrella policy sits on top of your homeowner’s and auto insurance policies to provide additional protection. For instance, if a neighbor slips and is injured on your icy sidewalk or a tree topples onto a car parked in front of your home, an umbrella policy may pick up the slack.

Just like other forms of insurance, you’ll need to shop around for the best umbrella policy. And keep in mind that



umbrella coverage kicks in only after other insurance is exhausted, and

umbrella policies usually carry deductibles equal to the required underlying limits for the auto and homeowners policies. Still, the cost of umbrella coverage usually isn’t prohibitively expensive. You may be able to obtain \$1 million in liability coverage for \$200 to \$300 a year. And you may get a discount for using the same carrier. That could prove a small price to pay for plugging the gaps in policies. ●

# It's A Question Of Proper Balance

**D**o you tend to put off certain chores—maybe cleaning the gutters, organizing your files, or changing batteries in smoke detectors? Most people can add another item to their to-do list: rebalancing a portfolio. However, unlike neglecting some of the others, failing to rebalance could result in significant financial losses.

Why do you have to rebalance in the first place? If you keep your holdings intact without making any changes, your preferred asset allocation will eventually get out of kilter. As a result, you could be exposing yourself to considerably more risk than you expect or consider acceptable.

Let's say you've determined the optimal approach for your needs is to maintain a portfolio with 50% allocated to stocks and 50% allocated to bonds and cash. (This is a purely hypothetical example and not indicative of any specific portfolio.) If the value of your stocks has increased during the past year, your portfolio might now have 75% in stocks, and 25% in bonds and cash. Stocks are historically more volatile than other

assets, and with that heavier concentration, you may not feel comfortable with your risk exposure. To get back to your previous allocation you could sell some shares and put the proceeds into bonds.

Similarly, if the value of your stocks has declined so that they represent only 35% of your portfolio, you may want to convert some of your other holdings into stocks.

There are several other direct and indirect reasons for rebalancing. Consider these three:

- It encourages you to cash in profits from investments that have done well and shift those funds to other investments that have merit but have yet to increase in value.
- It gives you the opportunity to review the mutual funds in your portfolio to see whether they're still performing up to your expectations.
- It can smooth out investment returns. All asset classes are cyclical, so rebalancing removes some of the inherent volatility associated

with investing.

How often should you rebalance? Some investors rebalance at least once a year. Our approach of choice is to rebalance whenever an asset class deviates from its target percentage by a specific amount – we like to use ten percentage points. For example, a portfolio with a 50% target allocation in stocks, would be rebalanced any time the value of its stocks rises to 60% or sinks to 40%.

Rebalancing is an important part of long-term investment management. It ensures that you are buying asset classes when they drop in value and don't overweight investments that have appreciated. Over a long period, it can make a major difference in a portfolio's performance and risk exposure. In addition, rebalancing can be managed for tax efficiency. Our firm handles rebalancing for clients we work with. ●



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2013. This deduction may be claimed in lieu of a higher education credit. The tuition deduction extension is retroactive to 2012. Finally, ATRA permanently extends enhancements for Coverdell Education Savings Accounts (CESAs), the tax exclusion for employer-provided education assistance and the student loan interest deduction.

### 6. Extensions Of Other Rules.

Besides those already mentioned, ATRA extends a host of other tax provisions for individuals, many of them retroactive to the beginning of 2012 (i.e., for provisions that technically expired). Most of the extended tax breaks are limited by dollar amounts. The list includes:

- Optional state sales tax deduction (in lieu of state income tax)
- Enhanced child tax credit, dependent care credit and adoption credit (and tax exclusion for adoption program assistance)
- Credit for energy-saving at home
- Monthly tax exclusion for certain commuting benefits
- Deduction for mortgage insurance premiums
- Deduction for classroom expenses of educators
- Tax exclusion for mortgage debt forgiveness
- Tax benefits for donating real estate for conservation purposes
- Tax-free distributions of IRA funds to charity by those age 70 ½ or over

### 7. Estate And Gift Taxes.

At long last, there's greater certainty in estate planning. Beginning in 2013, the unified estate and gift tax system permanently retains a \$5 million exemption and will be indexed annually for inflation (\$5.25 million in 2013), instead of plummeting from \$5.12 million in 2012 to \$1 million. The top estate tax rate, which was scheduled to jump from 35% in 2012 to 55% in 2013, is bumped up to 40%. ATRA also retains the

provision allowing "portability" of estate tax exemptions between spouses and coordinates various other aspects, including implementation of the generation-skipping tax.

These are just some of the highlights of the fiscal cliff law. We will be offering further guidance on the tax law changes,

