FERRELL
WEALTH MANAGEMENT INC.
Registered Investment Advisor

WEALTH MANAGEMENT NEWSLETTER

7 Major Tax Changes In The Fiscal Cliff Law

From 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, which begins in 2013, your effective top tax rate can reach 43.4%!

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 the upper crust still pays 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 2013. This deduction may be claimed in lieu of a higher education credit. The

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We Can Help You Finish 2012 And Navigate 2013

Happy New Year to you and your family! I hope 2013 is off to a great start. As you begin to gather your 2012 tax documents, I'd like to remind you that we are in our second year of offering tax and accounting services; and, in fact, we've updated the name of our affiliate accounting firm to Ferrell & Kelly, Certified Public Accountants. Tonya Kelly, Partner and Director of Tax Services, will be happy to assist you with your return or meet with you to review your income and estate planning in light of the American Tax Relief Act of 2012. She can be reached at 407-478-6596 or tkelly@ferrellkelly.com.

Markets ended 2012 having narrowly sidestepped a number of potential stumbling blocks. After Fiscal Cliff Part I was largely averted, markets responded favorably to the deal that kept income-tax rates constant for the majority of citizens and raised capital gains and dividend rates by less than many had feared.

At this point, many are feeling that there's always another crisis around the corner; but we've seen that it can be detrimental for investors to overreact. Although there are concerns all over the world, there also are bright spots.

We remain committed to navigating through the crises, and the opportunities, to help you reach your long-term goals.

Yours very truly,

James Ferrell
President

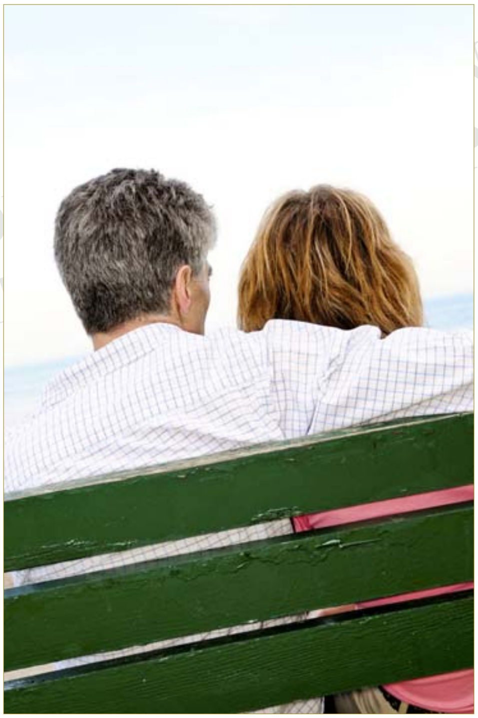
Will Your Retirement Assets Last?

If you've been scrimping and saving for retirement, you may be hoping to relax when that red letter day finally arrives. But recent developments—such as rock-bottom interest rates on fixed investments, the threat of higher taxes, and economic uncertainty—might give you pause. Could you outlive your assets in retirement?

Perhaps. According to a study by the Employee Benefit Research Institute, about 44% of those born between 1948 and 1978—encompassing most Baby Boomers and those in Generation X—haven't adequately prepared for retirement. Here are six steps to protect you:

1. Set aside funds for fixed expenses. Consider how much of your retirement money will go for necessities such as food and housing, transportation, health care, and utility bills. Then try to squirrel away enough in safe but liquid assets to pay those costs for three to five years. If you have that kind of cushion, you won't have to cash out of your other investments during a downturn.

2. Live long and prosper. Medical advances and other trends are helping people live longer than they did just a generation ago, and you'll need to plan accordingly. One possible hedge is to acquire long-term care insurance to cover at least part of the cost of an extended stay in a nursing home. But these policies vary, so proceed with caution. Another idea is to purchase an annuity that can provide steady income through retirement.



3. Don't be overly conservative. Naturally, retirement isn't the time to speculate wildly in the stock market, but relying too much on more conservative investments such as bonds can be detrimental, too. Retirees looking for increased yield may opt for long-term bond funds, but be careful about locking into an investment that could backfire if interest rates start to rise. Consider intermediate bond funds to complement your portfolio.

4. Remember the "i" word. Although inflation hasn't reared its ugly head in recent years, most financial analysts say it's only a question of when, not if, it will return in a big way. Take inflation projections into account when figuring out how much you'll need to sustain you through retirement.

5. Diversify your portfolio. Stock market volatility can be a nightmare for retirees living on fixed incomes. To keep your portfolio on a steadier course, follow the basic investment principle of diversification. And because overcompensating with ultraconservative investments may do more harm than good, seek alternatives that match up well with fixed-income investments and equities.

6. Reduce the tax bite. Although tax planning is especially difficult now, learn to adapt to changing rules and conditions. For instance, it may be sensible to convert savings from a traditional IRA to a Roth to secure future tax-free payouts. ●

It's A Question Of Proper Balance

Do 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 optional approach for your current needs is to maintain a portfolio with 50% allocated to stocks, 30% to bonds, and 20% to cash and other vehicles. (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, 15% in bonds, and 10% in cash and other investments. 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 and cash.

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

New Regulations Fill In Gaps On 3.8% Surtax

The tax landscape is changing dramatically in 2013. One potential pitfall is the advent of the new 3.8% Medicare surtax authorized by the 2010 Affordable Care Act. The surtax is tacked on to any regular income tax you owe on investment transactions.

At the end of 2012, the IRS issued proposed regulations explaining the rules for the surtax. The new regulations, plus answers to frequently asked questions (FAQs) posted on the IRS website, can help fill in the gaps left by the legal language of the legislation.

Basic rules: Beginning in 2013, a 3.8% Medicare surtax applies to the *lesser* of "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount. The threshold is $200,000 for single filers and $250,000 for joint filers. These figures aren't adjusted for inflation. For example, if you're a joint filer and have annual NII of $100,000 and a MAGI of $225,000, you owe no surtax. However, if your MAGI increases to $300,000 next year and your NII stays the same, you'll owe a surtax of $1,900 (3.8% of the $50,000 above the MAGI threshold, which is less than 3.8% of your $100,000 NII).

For an estate or trust, the surtax is levied on the *lesser* of undistributed NII or the adjusted gross income (AGI) above the beginning dollar amount of the highest tax bracket for trusts and estates. Due to the relatively compressed tax brackets for trusts and estates, this could have an even greater impact than the surtax on individuals.

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. Conversely, the NII definition specifically excludes certain items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans.

To arrive at NII, gross investment income is reduced by deductions that may apply. According to the FAQs on the IRS website, a few examples are investment income expenses, advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes related to items included in NII. The new regulations also clarify the following points.

Gains: Unless otherwise provided, a gain that is not recognized under other tax code sections doesn't count towards the 3.8% Medicare surtax, either. This includes gain deferred in an installment sale, gain from like-kind exchanges or involuntary conversions, and gain from the sale of a principal residence up to the exclusion amount ($250,000 for single filers and $500,000 for joint filers).

Estates and trusts: The surtax applies to ordinary trusts. Although it does not apply to business trusts or common trust funds, it may apply to pooled income funds. The tax doesn't apply to tax-exempt trusts, even if the trust is taxed on unrelated business income. Similarly, it doesn't apply to grantor trusts, although grantor trust income is treated as received directly by the grantor and may be taxable. While a charitable remainder trust isn't subject to the surtax, distributions to an income beneficiary may be considered NII (equal to the lesser of trust distributions or the current and accumulated NII of the trust). Generally, foreign estates and trusts aren't subject to the surtax.

NII items: Items normally considered NII, such as dividends or interest, are not treated as NII if derived in the ordinary course of a trade or business. But this exception requires that the business not be a passive activity or consist of trading in financial instruments or commodities. For a sole proprietor, this test applies at the individual level. For a taxpayer owning an interest in a pass-through entity such as an S corporation or partnership, the passive activity test is applied at the taxpayer level, but the financial trading test is applied at the entity level.

Although the new regulations provide some clarity, proceed with caution. Certain types of income that are not included in NII under a particular provision may still be swept in under other rules. For example, rents escaping inclusion under the exception to the passive activity rules may be subject to NII if the rental income isn't derived in the ordinary course of a trade or business. Moreover, this is doubtless not the final word on the subject, so be on the lookout for further updates. ●

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? For many investors, it makes sense to do it twice a year to keep a portfolio on track. Certainly, you should rebalance at least once a year. Another approach is to rebalance whenever an asset class deviates from its target percentage by a specific amount—perhaps five percentage points. For example, a portfolio with a 50% target allocation in stocks, would be rebalanced any time the value rises to 55% or sinks to 45%.

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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The Fiscal Cliff Law

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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, but please don't hesitate to call us about how the changes affect you personally. ●