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WEALTH MANAGEMENT INC.
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WEALTH MANAGEMENT NEWSLETTER

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

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Market Seems To Be Finding Its Legs Again

After a volatile ride from the end of May through the end of June, the stock market appears to be finding its legs again. The trigger for the sell-off was talk about the Fed beginning to taper its Treasury and mortgage-backed security purchases associated with quantitative easing.

Although the market reacted poorly, reduced purchases by the Federal Reserve should not necessarily be viewed in a negative light. Although it caused volatility, we believe this needed to happen. Since the 2008 financial crisis, investors have experienced only one mode for monetary policy direction – quantitative easing.

The Fed reiterated this was not a tightening of monetary policy and that the target rate should remain close to zero until at least 2015. The nearly $3.5 trillion balance sheet of the Fed illustrates just how stimulative the policy has been, and how much cash remains in the system that still needs to be put to more productive uses.

We believe the spike in yields, while unpleasant, may not lead to much more turmoil in the stock market than what we've seen already. Historical up moves in yields show stocks actually performing quite well – except during periods when yields were rising due to inflation problems.

Yours very truly,

James W. Ferrell,
MBA, CPA, PFS, CIMC, CFP, President

Owning REIT Shares Can Help Minimize Risk

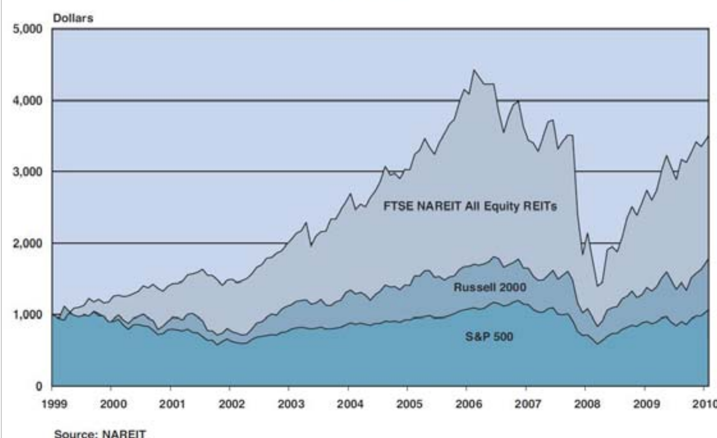
Diversification has been touted as the best way to avoid the steep ups and downs that can hit investors who rely too much on a narrow range of investment types. But the financial crisis of 2008-2009 ripped a huge hole in the diversification safety net, as most assets plunged together.

In the wake of the crisis, many investors are understandably concerned about the right mix of assets—stocks, bonds, real estate, cash, and other investments. For most people, it's not just a question of maximizing returns, but also of minimizing risk.

Investing in real estate through real estate investment trusts (REITs) can be part of the answer, especially when it comes to reducing volatility and risk, according to a new study commissioned by the National Association of Real Estate Investment Trusts (NAREIT).

"Diversifying the global portfolio to include real estate stocks alongside other stocks and bonds can potentially increase risk-adjusted returns and minimize expected losses for both risk-averse and moderate-risk investors," concludes the study based on 20 years of data from Morningstar Inc.

"The Role of Real Estate in Weathering the Storm" suggests that placing 14% to 20% of a global investment portfolio in real estate equities benefits those with low to moderate risk tolerance, especially when extreme risks such as a broad financial collapse are factored in.



Even including the real estate crash that started in 2006, REITs returned 10.63% from 2000 to 2009, compared with a negative 0.95% for the Standard & Poor's 500 stock index. That's partly due to the special tax status of REITs that forces the investments to return 90% of income as taxable dividends. Those dividends accounted for 56% of REIT total returns, compared with the 23% that dividends contributed to the returns of S&P 500 companies (between 1989 and 2012).

Many wealthy investors are on board. According to Spectrem, one third of investors with a net worth between $5 million and $25 million own REIT shares, and two-thirds of those with $15 million to $25 million own REITs. The average REIT stake of those investors is valued at $1.2 million.

A REIT is a company that owns and manages income-producing real estate. Most invest in specific types of property, such as offices, apartments, shopping centers, malls, industrial facilities, hotels, self-storage facilities, health-care properties, and more specialized properties.

According to Morningstar, REITs offer the potential for high yields, simplified tax issues, liquidity, and diversification. Drawbacks include a tendency for shares to lose value when demand rises for other high-yield assets such as U.S. Treasury bonds, and the potential for high property tax costs.

We can help you determine what portion of your portfolio to invest in REITs and what types of REITs best suit your financial goals. ●

Which Type Of IRA Do You Prefer?

There are two basic types of IRAs for retirement savers: the traditional IRA that has been around for decades and the Roth IRA, a more recent innovation. Each has pros and cons, so the choice often depends on your circumstances. To help you decide, here's a brief comparison.

First, be aware that both IRAs share some common traits. The contribution limit for 2013 for all IRAs (of either type) is $5,500 (up from $5,000 in 2012). If you're age 50 or older, you can kick in an extra $1,000. There's no current tax on earnings from contributions within either IRA. And the deadline for contributions is the tax return due date for the year of the contribution, with no extensions permitted.

Now let's examine the key differences.

1. Traditional IRAs. If your modified adjusted gross income (MAGI) exceeds a specified annual level *and* you actively participate in an employer retirement plan, the deductibility of your contributions will be phased out. The phaseout for 2013 occurs for a MAGI between $59,000 and $69,000 for single filers, and between $95,000 and $115,000 for joint filers. If your spouse participates in an employer plan but you don't, the phase-out range is between $178,000 and $188,000 of MAGI. Thus, many high-income individuals can't deduct any part of their contributions.

When you take distributions during retirement, you're taxed at ordinary income rates on the portion representing deductible contributions and earnings. Furthermore, if you're under age 59½ when you take a distribution, you must pay a 10% tax penalty (unless one of several exceptions applies).

2. Roth IRAs. Unlike with a traditional IRA, contributions to a Roth are never deductible, regardless of your MAGI. In addition, the ability

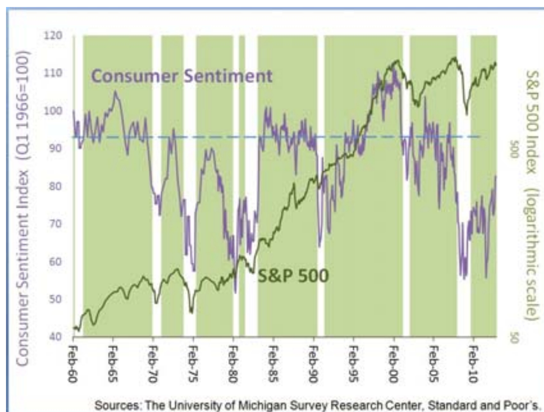
Investors Flee Stocks At The Wrong Time

The percentage of American households owning stock mutual funds dropped to 46.4% in 2011, and it has fallen every year since 2008, according to Investment Company Institute. In addition, outflows from domestic stock mutual funds in 2012 neared the record-breaking pace of 2008, the worst year ever for outflows.

Pessimism has been rampant. As 2013 begins, worries persist over the long-term federal deficit. Modern Portfolio Theory, the intellectual underpinning embraced by academia for evaluating investments for the long run, is now derided by many pundits. The Wells Fargo/Gallup Investor and Retirement Optimism Index turned negative at -8 in November 2012, down from double-digit positive scores earlier in 2012. A belief that America's best days are behind her seems pervasive.

How worried should you be? Maybe not as worried as so many others seem to be. Looking back at the historical performance of the consumer sentiment index versus the Standard & Poor's 500 stock index indicates that periods of extreme pessimism are actually good times for stocks.

The most recent data from University of Michigan's consumer sentiment index shows that that you would have to go back more than 30 years — to 1980 — to find consumer sentiment as low as it has recently dipped.



Sources: The University of Michigan Survey Research Center, Standard and Poor's.

The accompanying chart shows the consumer sentiment index dating back to 1960, and about the only time sentiment was as negative as it has been over the past couple of years was in 1980. The plunge in consumer sentiment in 1980 followed a recession, an oil shortage sparked by the American hostage crisis in Iran, an annual inflation rate of 14%, and the bursting of a bubble in the price of silver after the Hunt brothers failed to corner the market in the precious metal. That confluence of calamities in 1980 kicked off a raging bull market.

Today's economic worries are similar in many ways to 1980's woes. Global turmoil related to America's struggle with terrorism and Muslim fundamentalists dominates the headlines, threatening oil production in the Arab world. Massive monetary stimulus by the Federal Reserve has sparked inflation fears and the price of gold spiked higher than ever in the last couple of years. America seems unable to muster the strength to fight its fiscal crisis.

But just as happened in 1980, stocks over the past couple of years have marched higher. And, as the accompanying chart assembled by Fritz Meyer Economic Research illustrates, it's not unusual for stocks to rise steadily higher precisely when consumer pessimism is at its worst.

Investor perceptions and consumer sentiment are often at odds. Wall Street reality—earnings growth and rising stock prices—governs stock prices. As a result, even as consumer sentiment plunges, you could see a rally in stocks.

To be sure, economic and political problems plaguing the U.S. are serious and must be addressed. The federal debt, downgrading of the U.S. Government's credit rating, and threat of terrorism remain very real problems. But the pessimism these problems engender doesn't necessarily stop the stock market from rising if corporate earnings growth holds up, and that's what occurred in recent months.

In the aftermath of the 2008 global financial crisis, consumer sentiment has recovered. As history shows, however, it can take years for a full recovery in consumer sentiment to take hold. In fact, stock prices must rise for an extended period before consumer sentiment fully recovers following economic trauma. Stock prices are always out in front of consumer perceptions.

So, when you hear news about the extreme pessimism over the economy and record outflow from stock mutual funds, remember these lessons from history. The stock market in 2012 showed an astounding total return of 16%, while investors fled stock mutual funds in droves. Investors historically leave the stock market and become pessimists at precisely the wrong time. While past performance is never a guarantee of future results, it appears that familiar pattern was repeated in 2012. ●

to make full contributions to a Roth is phased out for 2013 for a MAGI between \$122,000 and \$127,000 for single filers, and between \$178,000 and \$188,000 for joint filers.

However, qualified distributions from a Roth in existence for at least five years are 100% tax-free. This includes distributions made (1) after age 59½, (2) due to death or disability, or (3) used to pay qualified first-time homebuyer expenses (lifetime limit of \$10,000). Other distributions are taxed at ordinary income rates under "ordering rules," which treat contributions as coming out first, then conversion and rollover amounts, and finally earnings. So a portion or all of a payout still may be tax-free.

Due to the back-end benefits, you might convert funds in a traditional IRA to a Roth, paying tax in the year of conversion. If it suits your purposes, you can "undo" the conversion by the tax return due date (including any extension).

Which type of IRA is best for you? Figure it out by factoring in all the variables. We can help you crunch the numbers. ●

Saving For Retirement At All Ages

Financial planners often are asked, “When should I start saving for retirement?” Although everyone’s circumstances differ, the answer usually is a variation on this theme: As soon as possible. But that doesn’t mean it’s ever too late to begin, or that you’ll have the same financial priorities at every age. When you’re embarking on a career, you may not have much extra income to set aside, but you can work on establishing sound financial habits. Later, though you’ll likely earn more, you’ll also likely have greater obligations—supporting your family, paying a mortgage note, and, yes, saving for retirement. Still other factors may come into play as you approach your golden years.

Consider these basic approaches during different financial stages of your life.

In your 20s. Retirement may seem several lifetimes away. What’s more, the salary you earn during your early working years likely won’t provide much cushion for savings. But you may be surprised by how much you can accumulate if you’re dedicated, thanks largely to the power of tax-deferred compounding. For instance, if you save $1,000 a month and earn 8% on your savings compounded annually for 40 years until retirement, you will amass a staggering $3,271,022.95. (These figures are hypothetical and not indicative of any particular investment.)

The easiest way for most people to sustain tax-deferred growth is through a 401(k) or another tax-advantaged retirement plan. If your employer provides matching contributions, try to contribute at least as much as you need to qualify for the maximum match.

In your 30s and 40s. These are prime earning years, but you also might incur substantial expenses raising the kids, buying and maintaining a home, and paying for college. Nevertheless, you should do your best to stay disciplined and contribute as much as you can to your retirement plans. For 2013, you can defer up to $17,500 of salary to your 401(k). In addition, if you establish an IRA, the annual contribution limit is $5,500. Meanwhile, although contributions to a Roth IRA are never tax-deductible, future payouts may be tax-free. ï€†

In your 50s and 60s. This may be when you earn the highest salary of your career. If the kids are out of college and the mortgage is paid off, it’s truly time to make hay while the sun shines. Although you might not have been as diligent at retirement saving in the past as you would have hoped to be, you can recover lost ground quickly by socking away more in your retirement plans at this point in your life. For 2013, you can contribute an extra $5,500 to a 401(k) and an additional $1,000 to an IRA, above the limits already discussed. And you can save still more in taxable accounts outside your retirement plans. ●

New Law Poses Tax Risks

(Continued from page 1)

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. Depending on your situation, you might accelerate income or capital gains into the current year to avoid higher taxes next year, or you could postpone income or gains to next year to avoid higher taxes this year. We can work with your tax advisor to help you decide what makes sense in your situation. ●

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