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You Have Entered The Twilight Zone—Of Taxation

Rod Serling, creator of the classic science-fiction TV series, "The Twilight Zone," could not have come up with a stranger tax structure. You have entered a five-dimensional tax zone, a tax labyrinth so strange it almost seems like science fiction.

There's more to the federal income tax system than just a single calculation. In fact, upper-income taxpayers—especially those generating income from investments—actually must cope with five "dimensions" of taxation: (1) ordinary income tax; (2) capital gains and losses; (3) the alternative minimum tax; (4) the net investment income tax; and (5) a reduction of itemized deductions and personal exemptions. Here's a quick rundown:

1. Ordinary income tax. This is the standard tax calculation we're all familiar with. The income you earn generally is taxed under a graduated rate structure with seven tax brackets: 10%; 15%; 25%; 28%; 33%; 35%; and 39.6%. If you're in the top tax bracket, any extra income you earn is taxed at the 39.6% rate. Tax deductions and credits can be used to offset your tax liability based on these ordinary income rates, but certain special rules may apply (see #5).

Furthermore, under the "kiddie tax," if investment income of a dependent child exceeds an annual threshold ($2,000 in 2014), the excess generally is taxed at the top tax rate of the parents. This can hike the overall family tax bill.

2. Capital gains and losses. The tax law provides separate tax treatment for capital assets such as securities and real estate. Generally, gains and losses from capital assets are used to offset each other. Long-term gains from assets held longer than a year qualify for a maximum 15% tax rate, but the rate increases to 20% for those in the top two ordinary income tax brackets. Qualified dividends also benefit from these preferential tax rates.

In addition, you can use excess capital losses to offset up to $3,000 of ordinary income, and you can carry additional losses over to next year. With that in mind, "harvesting" losses is a common year-end tax strategy.

3. Alternative minimum tax. The alternative minimum tax (AMT) runs on a track parallel to ordinary income tax. This complex calculation involves certain additions and adjustments before subtracting an exemption amount based on your tax filing status. However, the exemption is reduced for high-income earners. There are just two tax brackets—26% and 28%—for taxpayers with AMT liability.

At tax return time, you compare your ordinary income tax result to the AMT result and effectively pay the higher of the two. This "alternative" tax often catches unwary taxpayers by surprise.

4. Net investment income tax. The "net investment income" (NII)

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Retirement Saving Takes Time And Must Be A Priority

The bad news: If you're like many people, you haven't made adequate plans to ensure a comfortable lifestyle throughout retirement. The good news: You may still have time to do something about it.

According to a recent study of almost 1,500 Americans by the National Bureau of Economic Research (NBER), many people lack essential financial literacy, and for most, prospects for a secure retirement may be even dimmer than feared. According to NBER:

- Fewer than one in 10 respondents was able to answer basic financial questions correctly.
- About 50% said they had trouble keeping up with monthly bills.
- Only about half had "rainy day" funds large enough to cover expenses for three months in case of lost income.
- Almost a third had done something resulting in an interest charge or fee for credit card charges.
- Only 42% said they have tried to figure out how much to save for retirement. Of those between the ages of 45 and 59, more than half said they hadn't calculated how much they'll need for retirement.
- Only 51% had a retirement account with an employer, and just 28% had another retirement account such as an IRA.
- During the past year, 9% of those with a 401(k), IRA, or another retirement account tapped the account prematurely.

The takeaway? Start now, during your working years, to get up to speed on financial matters and take steps to protect your future.

Jim Joseph, CFP®
Vice President

Markets May Not Be Certain, But Experience Is

Have you ever wished you could do it all over again? Experience can be a great teacher, and it's natural to imagine that with the benefit of hindsight you would have made better decisions about everything from raising your children to managing your financial affairs. And while that may or may not be true, what is certain is that you can offer younger family members some of the insight you've acquired along the way.

Here are some thoughts you might pass along:

1. When you get a pay raise or a new higher-paying job, consider earmarking at least part of the additional money for retirement savings. You'll be amazed by what tax-deferred compounding can do to even relatively small sums over the course of several decades. And using raises to increase your contribution to a 401(k) can be relatively painless. Ratchet up your saving rate by a percentage point or two each year and you'll soon reach the maximum for annual pre-tax contributions to 401(k)s and similar employer-sponsored plans—$17,500 in 2014 if you're younger than age 50. Beginning at 50, you'll be eligible to contribute an extra $5,500 a year.

2. Try to resist the siren song of early retirement. Leaving your job in your 50s may be tempting, but it runs counter to several financial realities. Most people have not saved enough to retire comfortably even at the traditional age of 65, and quitting early can mortgage your future in two ways—reducing the amount you can save while extending the time that your savings must support you. By the same token, however, every year you keep working improves your situation. Moreover, as life expectancies increase, more and more people find they want to stay on the job at least part-time, and not only for financial reasons. Working can help keep you engaged and healthy, particularly if you find something you really like to do.

3. Consider postponing Social Security. You can begin receiving benefits as early as age 62, but each year you delay will increase the amount of your monthly payment, and if you wait until age 70, you'll get 76% more than if you had started drawing benefits at 62. And most people will live long enough to get a larger total payout if they begin later.

Don't feel like you have to go it alone in making financial decisions. FSA can help you make sense of complex financial markets and chart a comfortable path toward your goals. We can assist you in deciding how much to save, how to allocate your investments, how to weigh the pros and cons of buying a home and other major financial choices, and when the time comes, how to deploy your retirement nest egg. We're here for you and your extended family – just let us know. ●

Count On The Portability Provision

Though it's still true that you can't take it with you, a recent tax law change makes it easier to reduce or eliminate estate tax liability for your heirs. Thanks to a "portability" provision that's now part of the law, any unused portion of the individual exemption from federal estate tax that isn't used by the estate of the first spouse to die may be claimed by the surviving spouse's estate.

This special estate tax break, first enacted in 2010, was set to expire after 2012. However, the American Taxpayer Relief Act (ATRA) extended it for 2013 and thereafter. Barring drastic change, you can count on portability for the foreseeable future.

Under ATRA, the federal estate tax exemption is locked in at a generous $5 million that is increased annually to account for inflation. (The exemption for 2014 is $5.34 million.) As a result, a couple in 2014 can transfer up to $10.68 million without incurring a dime of federal estate tax.

Suppose a husband owns $4 million on his own, his wife has $3.5 million, and they hold $2.5 million in both their names—jointly with rights of survivorship, in legal jargon. Each spouse's will leaves his or her entire estate to the other spouse and, upon the death of that spouse, to the couple's children.

Now suppose that the husband dies first in 2014. Because all of his individually owned assets pass to his wife, his estate needn't use any part of his federal estate tax exemption. (Spouses normally can inherit an unlimited amount from each other without estate taxes.) So the wife now owns all of the couple's assets, worth a total of $10 million. When she dies, that $10 million in assets goes to the couple's children. Without portability, the wife would have only her own exemption, and that would leave her estate responsible for estate taxes on $4.66 million (the $10 million in assets

Figuring Out How Much You Need In Retirement

At some point, almost everyone asks this question: How much do I have to save for retirement? Of course, there's no easy answer, but what may be even more disconcerting is the possibility that this may be the wrong question. It might be more beneficial to figure out how much income you will need annually in retirement than it is to pinpoint the amount you should try to set aside.

Start by Changing Your Mindset

You are who you are and that isn't likely to shift 180 degrees in retirement. Sure, you'll have more time to travel or pursue other activities, but you'll still be the same person with the same basic values, interests, and inclinations. Armed with this knowledge, you may want to shift from the notion of accumulating a specific amount for your retirement to figuring out what your expenses will be on a year-to-year basis.

Once you understand your financial liabilities, you'll be better prepared to devise a retirement saving strategy and at the same time eliminate fears that your money won't last long enough. Targeting a "magic number" for the future can be stressful. According to a recent survey, 82% of the respondents who have dependents and are age 44 through 49 were more worried about outliving their money than they were about death. Concentrating more on your personal needs can help alleviate concerns.

Begin this process by calculating your true retirement liability. Rather than asking "How much money do I need to retire?" try to determine "How much money in future dollars will I need each year during retirement?"

Calculate Your Expected Expenses

Where and how will you spend most of your money during retirement? Everyone's situation is different, but recent statistics from the Bureau of Labor Statistics indicate the typical results, some of which you may find surprising. Here are a few findings to ponder about retirees age 65 and over:

- They spend 34.2% of their money on housing. If you're already an empty nester, or expect to be one in the near future, you might look to downsize soon to take advantage of the equity built up in your home. In any event, consider working out a plan that lets you live more economically than you could when you were in the middle of a career and raising kids.
- They spend 16% of their money on transportation. And it's not paying for gasoline that hurts the wallet most; the bulk of these expenditures come from buying new cars. Instead of succumbing to the temptation to rush out and get a new vehicle every three years, consider keeping your existing car or buying a pre-owned model.
- They spend only 0.5% of their money on education. Just because you're retired doesn't mean you should stop learning. Going back to school on a part-time basis—even if you do it online—could improve your lifestyle and open up new opportunities.

This is just the tip of the iceberg. Also consider health care—often a big expense—food, entertainment, and retirement travel. No one knows better than you do where your money will go.

4 Steps to Prepare

It can be challenging to change the way you think about retirement planning, but here are four steps that may help:

1. Make retirement planning a top priority. It's been said that any plan is better than no plan at all. You're one step ahead of the game if you've already started to focus on the challenges ahead. Ignoring it could be the worst option.

2. Seek the counsel of others. We would be glad to provide whatever assistance you need in meeting your goals. It is often helpful if an impartial voice can provide guidance on emotional topics such as selling the family home or bypassing luxuries.

3. Create a range of estimates for what you will spend. Even if you knew with certainty how long you would live and how much you would spend, it still would be extremely difficult, if not impossible, to estimate their retirement liability exactly. Make reasonable estimates within a range and review the analysis annually.

4. Start sooner rather than later. Regardless of your age, it's not too early to begin planning. Your circumstances could change, so you'll need to build some flexibility into the plan. That's far easier at an early age than it is when retirement is knocking on the door. ●

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minus her $5.34 million exemption). At the current 40% estate tax rate, the estate would owe more than $1.8 million—money that wouldn't go to the children. With portability, however, the combined exemption of $10.68 million more than covers the $10 million in the estate, and the heirs pay no estate tax.

As beneficial as the portability provision can be, it won't necessarily solve every potential estate-planning problem. For example, it still might be a good idea to establish a bypass trust, a tool that, before portability, could be used to maximize the estate tax exemptions of married couples. Although no longer needed for that purpose, a bypass trust still could be used to protect assets from creditors, guard against other tax consequences, such as the generation-skipping tax, and be especially helpful in allocating assets when one or more spouse has children from a previous marriage. ●

5 Tasty Tips For A Spending Diet

Whether it's the holidays, vacation season, or any other time of the year when you take your spending up a notch, the aftermath can be sobering. Credit card bills and bank statements arrive. Suddenly, you feel bloated—and resolve to cut some of the fat from your budget. These five steps could help you go on a spending diet to improve your financial health:

1. Count the "calories." Where is the extra weight really coming from? Before you can trim expenses, you need to know what they are. But documenting every single item can be tedious and nerve-wracking. For many people, a better option is to make a list, based on your statements, that provides a ballpark estimate. Then you can determine what percentage of income goes toward necessities, such as housing and food costs, and what is discretionary. Aim to save at least 20% by cutting back on the luxuries.

2. Focus on the "meat and potatoes." Don't ignore those major monthly costs—your mortgage, car loans, and insurance premiums. Look for ways you can spend less on these "fixed" items. For instance, it might make sense to refinance the mortgage and shop for less expensive auto insurance. Similarly, you might be able to reduce commuting costs by carpooling or switching to mass transportation.

3. Stick to the daily regimen. Just like you can't lose weight by starving one day and splurging the next, a savings diet requires a regular routine. Consider the impact of cutting your daily spending by an average of $3 or $4. That could add up to more than $100 a month, and over $1,200 a year. Small changes can multiply into a much bigger impact.

4. Give yourself an occasional break. Even if you're watching your spending waistline, you don't have to be good all the time. If you enjoy some small luxuries—going to the movies, say, or getting a manicure—you're entitled to treat yourself. But watch out for wasteful spending on upgrades that are way beyond your pay grade. Figure out what's truly important to you to decide where you can cut costs.

5. Try an all-cash diet for a week. When you put away your credit and debit cards, you may find that you're less likely to spend frivolously. This also helps you to pay more attention to how and what you're spending, and to prioritize your preferences.

Finally, don't just sit on the savings. Take the money you've managed to set aside on your diet and invest it where it can provide benefits in the future. If you've been skimping on your 401(k) or IRAs, those are good places to stash the extra cash. This will allow you to indulge more during retirement years when you're no longer pulling down a paycheck. ●

Twilight Zone Of Taxation

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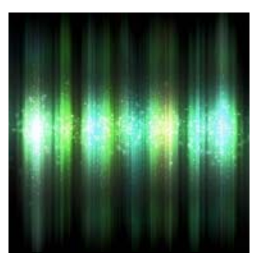
tax is a new wrinkle that taxpayers have to deal with for the 2013 tax year and beyond. You must pay a 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—$200,000 for single filers and $250,000 for joint filers. For this purpose, NII 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. But some items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans, are excluded from the definition.

The NII tax is an add-on to the ordinary income tax calculation. Thus, your combined top tax rate can be as high as 43.4%!



5. Reduction of itemized deductions and personal exemptions. Two tax law provisions that were reinstated in 2013 may affect upper-income taxpayers adversely. Under the "Pease rule" (named for the congressman who originated it), certain itemized deductions, including those for charitable donations, state income tax, and mortgage interest, are reduced if your adjusted gross income (AGI) exceeds an annual threshold. For 2014, the threshold is $254,200 of AGI for single filers and $305,050 for joint filers. The total of your itemized deductions covered by the Pease rule is reduced by 3% of the amount above the AGI threshold, but not by more than 80% overall.

A similar rule phases out the tax benefit of personal exemptions. Under the personal exemption phaseout (PEP) rule, exemptions are reduced by 2% for each $2,500 (or portion thereof) of your AGI that exceeds an annual threshold. The PEP thresholds are the same as those for the Pease rule.

Beyond these five, a sixth dimension exists for most taxpayers—state income taxes. ●

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