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Watch Out For Tax Traps In The Fiscal Cliff Law

There's a lot to like for most taxpayers in the American Taxpayer Relief Act (ATRA), the eleventh-hour legislation that Congress enacted just as we were about to go over the "fiscal cliff." The new law generally preserves favorable income tax rates on investment income, although some upper-income investors now must pay higher rates. And ATRA provides much-needed relief from the alternative minimum tax (AMT) and estate taxes, while extending a slew of other tax breaks, though with a few modifications.

But there's also some bad news tucked away in the 157 pages of the law. In particular, there are two new tax traps that effectively could reduce your tax refund for the 2013 tax year or increase the amount you'll have to pay Uncle Sam. The two potential stumbling blocks are commonly referred to as the "Pease rule" and the "PEP rule" (for "personal exemption phaseout").

The Pease Rule. Under the Pease rule (named for the congressman who initially championed this amendment in the 1980s), most itemized deductions are reduced by 3% of the amount that your adjusted gross income (AGI) exceeds a specified dollar threshold, though they can't be cut by more than 80% overall. This provision in the tax law was phased out gradually by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). However, it was scheduled to return in 2011, before the 2010 Tax Relief Act provided a temporary reprieve through 2012. Now, finally, the Pease rule has been revived permanently.

At least ATRA raises the dollar thresholds from the levels that originally were scheduled for 2013. Previously, the limit would have been \$178,150 for both single and joint filers, based on an inflation adjustment. Under ATRA, the dollar threshold is \$250,000 for single filers and \$300,000 for joint filers. Make more than that, though, and you could stand to lose a portion of your itemized deductions due to this rule.

Example: Suppose you're a joint filer with an AGI of \$400,000 in 2013. That's \$100,000 above the threshold, and so the \$50,000 in itemized deductions that you claimed will be reduced by the Pease rule to \$47,000 – (\$50,000 minus 3% of \$100,000).

Note that the Pease rule applies to many of the deductions that are likely to produce big write-offs, such as charitable donations, mortgage interest, state and local income taxes, and property taxes and miscellaneous expenses. On the other hand, it doesn't apply to deductions for medical expenses, investment interest, or casualty and theft or gambling losses, because those already have their own built-in thresholds.

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Just About Everyone Needs A Living Trust

We get the question often: Who needs a living trust?

Here are some examples of people who need one:

- If you have an estate worth more than \$100,000 and want to avoid probate upon death and avoid property guardianship upon disability.
- If you have real estate in multiple states.
- If you have separate children from previous marriages and don't want your children to be accidentally disinherited.
- If you are infirmed or elderly.
- If you are a parent with minor children.
- If you have a large estate and want to avoid federal estate taxes and state death taxes.
- If you have married children and want to protect their inheritance from divorcing spouses or lawsuits.

So the answer is: Most of us!

We can help. We will work with an attorney to create estate planning while at the same time helping to formulate a roadmap for your overall life-financial plan.

John

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 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. ●

Where Will You Live After You Retire?

Planning your retirement involves far more than determining how much income you'll need. One of the most basic and important decisions is where you want to live during your retirement years.

Choosing a location is something you can start working on early, as much as five to 10 years before you leave work. Don't wait until retirement is just around the corner, because the process of comparing and contrasting different regions can be time-consuming and eye-opening.

The first step is to decide whether you want to remain where you are or move to a new place. It's a very personal starting point, and often it will take into account proximity to family members and attachment to your community.

For those who decide to move on, here are some steps to make sure you end up in a happy place:

- **Discuss your desires.** Do you dream about lying on a beach with the latest bestseller, or reeling in giant marlin from deep water? Do you envision attending symphonies and plays, or riding horses and hiking up mountains? Will you play golf or visit museums and the library? Do you want lots of sunshine or four seasons? Small town or big city? Lots of restaurants or lots of bait shops? Start by writing down a clear picture of your life in retirement.
- **Do your homework.** Start matching real places with your dream retirement activities and environment. Look into weather, demographics, health care costs and health care availability for hospitals and medical specialties, crime statistics, and other factors using popular "Best Places To Retire" guides. Generate a list of three or four places that look like good matches.
- **Dip your toe in.** Schedule a trip to each area, and make it a long

10 Reasons For The IRS To Flag Your Return

What sets off alarm bells at the IRS? Due to limited resources, the IRS only audits around 1% of all federal individual tax returns, while the other 99% skate through unexamined. Nevertheless, it pays to keep in mind these 10 “red flags” that could increase the chance you’ll be tapped for an audit.

1. High income. The audit rate for 2011 tax returns, which was about 1.11% overall, jumped to 3.93% for taxpayers with income of $200,000 or more. That’s almost one out of every 25 returns. The IRS tends to chase the “big money,” and while that’s no reason to earn less, you should realize that higher income exposes you to a greater audit risk.

2. Unreported income. The IRS computers match up the income listed on W-2 and 1099 forms with the income reported on individual returns. You’re likely to draw IRS scrutiny if you don’t report all of your taxable income or if you underreport the total, even if an omission is inadvertent. Check your tax forms to ensure the information is accurate.

3. Large charitable gifts. Besides providing personal satisfaction, deductions for charitable gifts can offset highly taxed income on your return. But the IRS may become suspicious if the amount you deduct is disproportionate to your income. In particular, make sure that deductions for gifts of property are legitimate and include an independent appraisal when required.

4. Home office deductions. If you qualify, you can write off your direct costs of using part of your home as an office, plus a percentage of everyday living expenses such as property taxes, mortgage interest, utilities, phone bills, insurance, etc. But the basic rule is that you must use the office “regularly and exclusively” as your principal place of business. Simply doing work at home when your main office is elsewhere won’t cut it.

5. Rental real estate losses. Generally, “passive activity” rules prevent investors from deducting losses on rental real estate. But a special exception allows a loss deduction of up to $25,000 for “active participants,” subject to a phase-out between $100,000 and $150,000 of adjusted gross income (AGI). Another exception applies to qualified real estate professionals. The IRS may zero in on taxpayers claiming losses under either exception.

6. Travel and entertainment expenses. This is often a prime audit target. IRS agents particularly look for self-employed individuals and other business owners who claim unusually large write-offs for travel and entertainment expenses and meals. Note that the tax law includes strict substantiation rules that must be followed in order to deduct any of these expenses.

7. Business use of cars. Another area ripe for abuse by taxpayers is the use of a vehicle for business purposes. The annual amount you can claim via depreciation deductions for the vehicle, based on percentage of business use, is limited by so-called “luxury car” rules. IRS agents have been trained to ferret out taxpayer records that don’t measure up. Another danger signal is a claim for 100% business use of a vehicle, especially if another vehicle isn’t available for personal use.

8. Hobby losses. As a general rule, you can deduct expenses for a hobby only up to the amount of the income it produces. You normally can’t claim a loss for the activity, unless your involvement rises to a level of a bona fide business. Usually, an activity is presumed not to be a hobby if you show a profit in any three out of the past five years, but the IRS can rebut this presumption.

9. Foreign bank accounts. The IRS has started clamping down on taxpayers with offshore accounts in “tax havens” in which banks may not disclose account information. Failure to report foreign income can trigger steep penalties and interest. If you have foreign bank accounts, make sure you properly report the income when you file your return.

10. Cash businesses. Finally, if you operate a small business in which you’re generally paid in cash—for example, if you own a car wash, restaurant or tavern, or a hair or nail salon—the IRS is more likely to examine your return. Past history indicates that cash-heavy taxpayers may underreport their income or, in some cases, not report any income at all. Accordingly, the IRS remains on high alert.

These red flags certainly don’t mean you should shy away from claiming the tax breaks you rightly deserve. Just be prepared to defend your turf if the IRS ever comes calling. ●

vacation if possible, up to several weeks. Try to visit each area at different times (e.g., when weather isn’t ideal) and experience as many things as you can while there. Are the people friendly? Do any unexpected difficulties pop up? Does it match your vision?

- **Consider longer visits.** If your short-term visits leave you uncertain, consider renting your current home out while you spend even more time in your potential locations. Take several months to get a real feel for the area and make your decision. After all, you hope to live there for a long time to come!

Once you decide on a location, it’s time to look at some financial factors, starting with the sale of your current home. Ask several realtors for an estimate, and compare what you’re likely to clear from the sale with what you’ll need in your new area. We can help you do these calculations, and we’ll add any expected surplus into your income calculations, and take into account tax and other implications.

Relocating can be one of the most stressful aspects of retirement. Work with a financial advisor who understands all the state and estate tax implications and how moving affects your financial outlook and quality of life. ●

Avoid These 7 Investment Mistakes

One thing that can be puzzling about stock market investors who have struggled in the past: They make some of the same mistakes over and over. Here are seven prime examples.

1. You try to "time" the stock market. Typically, timing strategies are based on selling stocks when you believe the market has topped out and buying when you think it has hit rock bottom. The problem is that nobody—and we mean NOBODY—has a crystal ball that's foolproof. It's far better to stick with a well-diversified, balanced portfolio based on your personal circumstances.

2. You have zero patience. If you're looking for instant gratification, the stock market will disappoint you more often than not. Just as for the tortoise and the hare, slow and steady usually wins the race, while those who act too swiftly finish behind. Be content to hold some stocks for a long time before you reap rewards.

3. You refuse to recognize reality. All too often, investors operate with blinders on, but the cold hard facts can't be ignored. If you have a favorite stock you were convinced would turn a profit and it simply hasn't worked out, don't throw good money after bad. Dump the losers and hold on to the winners without allowing emotion to rule the day.

4. You put all of your eggs into one basket. No matter what the projections are for any particular stock, sector or asset type, it's not smart to bet your entire wealth on its performance. Diversification is a key element of a sensible plan for virtually every investor. It's all about balancing the search for reward with the need to reduce risk. Although there's less chance you'll make a killing if you diversify, you reduce your exposure to a catastrophe.

5. You overemphasize past performance. It may be boilerplate language in investment prospectuses and related materials, but it's also true: "Past performance is not necessarily indicative of future results." Don't build your portfolio around particular stocks just because they've been profitable without evaluating their current and future prospects.

6. You ignore the impact of taxes. It only makes sense to consider the tax ramifications of your investment decisions—especially now, with higher income tax and investment tax rates for high-income investors and the arrival of a new 3.8% Medicare surtax in 2013. But it also can be a mistake to let taxes drive your decisions. Weigh all of the relevant economic factors when you buy or sell stocks.

7. You don't have a plan. Many investors take a hit-or-miss approach to their portfolio. They buy and sell on whims without coordinating their activities. But you're more likely to be successful if you develop an overall plan that is suitable for your situation. Having a strategy and having the discipline to stick with it is the hallmark of successful investing. We would be glad to provide whatever assistance you need. ●

Watch Out For Tax Traps

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The PEP Rule. The PEP rule has followed a path similar to that of the Pease rule. It was phased out gradually by EGTRRA before reinstatement of this provision was postponed by the 2010 Tax Relief Act. Now the PEP rule is back with a vengeance for 2013 and thereafter.

This onerous rule reduces the total amount of personal exemptions you may claim—including for yourself, your spouse (if you're married), and your dependents—by 2% for each $2,500 (or portion thereof) by which your AGI exceeds a specified dollar threshold. Each exemption in 2013 is $3,900. Unlike the Pease rule, there's no limit on the overall amount of the reduction with the PEP rule, so personal exemptions could be phased out completely for some high-income taxpayers.

As with the rule for itemized deductions, however, ATRA raises the applicable thresholds for the PEP rule to $250,000 for single filers and $300,000 for joint filers. Without this change, the thresholds for 2013 would have been $178,150 for single filers and $267,200 for joint filers. Yet the reduction of exemptions still can be significant.

Example: Suppose you're a joint filer with an AGI of $400,000 in 2013 and you're entitled to a total of four personal exemptions. Under the PEP rule, your exemptions are reduced by 2% of each $2,500 above the limit for AGI, or a total of 80%—40 ($100,000 divided by $2,500) times 2%. Therefore, your personal exemptions of $15,600 ($3,900 times four) are reduced all the way down to $3,120.

The reinstatement of the Pease and PEP rules could affect tax planning for high-income people. For instance, when appropriate, you might accelerate or postpone certain deductible expenses at the end of the year, depending on your personal circumstances. Make sure you take all of the prevailing rules into account. ●