CREATIVE
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How 2013 Tax Changes Impact Asset Accumulation

As U.S. taxpayers submit their 2012 income tax returns ahead of the April 15, 2013, deadline, it's a good time to get up to speed on the new rates in effect for 2013. Most of the changes delineated in the American Taxpayer Relief Act of 2012 (ATRA) actually provide minimal "relief" for those with high incomes and substantial investments, but truth in labeling is not a requirement for Congressional legislation. However, it is the taxpayer's responsibility to know the changes and file accurate returns. Here are some of the high/low lights:

1. A new tax rate on ordinary taxable income. Previous tax rates on income progressed through six brackets, beginning at 10%, then rising to 15, 25, 28, 33 and 35% as total income increases. These rates and income brackets remain the same, but for single filers with taxable income above $400,000, or married filers with income over $450,000, a new top rate of 39.6% has been added. (An important distinction: "Taxable Income" is defined as adjusted gross income minus deductions, so it is possible that individuals or households with adjusted gross incomes greater than $400,000 or $450,000 could be taxed at a lower marginal tax rate due to deductions.)

2. Higher long-term capital gains and dividend income tax rates for those with top-bracket incomes. For those whose taxable income falls below the $400,000 or $450,000 threshold, tax on investment income received as dividends or capital gains remains at 15 percent. But for taxpayers with the higher incomes noted above, their rate increases to 20 percent.

3. A 3.8% Medicare surtax on investment income. This item was part of the Patient Protection and Affordable Care Act of 2010, but didn't become effective until 2013. Intended as a revenue offset against the costs of the health care legislation, the so-called Medicare surtax imposes a 3.8% additional tax on net investment income, including:

– income from interest,
– dividends and capital gains,
– non-qualified annuity income,
– royalties and rents.

The surtax does not apply to:

– tax-exempt interest from municipal bonds,
– qualified pension, profit-sharing, and stock bonus plans,
– qualified annuity plans,
– IRAs and Roth IRAs,
– other deferred compensation plans of state and local governments and tax-exempt organizations.

The threshold for the Medicare surtax applies to taxpayers with modified ***adjusted gross income*** above $250,000 for married filers and $200,000 for singles. For those already paying 20% tax on capital gains and other investment income, the tax on investment income now becomes 23.8 percent.

In addition to these specific tax increases effective 2013, ATRA also phases out many deductions to income for those in the top brackets. These include lower deduction amounts for personal and dependent exemptions as adjusted gross income goes up, and up to 80% reduction to deductions for mortgage interest, charitable contributions, and property taxes.

In a theoretical calculation for a January 7, 2013, *MoneyWatch* article, columnist Ray Martin calculated the impact of these new taxes on a married couple with a taxable income of $650,000. Martin also assumed the couple received $10,000 in capital gains and $10,000 in dividend income from their portfolio. (If the couple had a taxable investment portfolio of $750,000, the combination of capital gains and

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dividends would represent slightly less than a 3% portfolio return.)

If these financial numbers were identical to those in 2012, Martin concluded the increased taxes and decreased deductions would result in an additional $30,000 sent to the U.S. Treasury for the 2013 return. For a household at this income and asset level, this tax increase is less than 5% of taxable income, which perhaps doesn't seem too steep. But, put another way, it's also enough to pay one year of out-of-state college tuition at most public universities.

If your personal circumstances place you close to these income thresholds, it may be prudent to re-evaluate your saving and investment allocations. Although it's not advisable to make financial decisions based exclusively on tax consequences, the rising "carry costs" in the form of taxes can substantially diminish your real returns.

Don't forget the opportunity cost on investment income taxes

The decrease in investment return isn't simply the higher tax on investments. Taxes paid today incur an opportunity cost going forward, because an amount needlessly sent to the IRS could have compounded for your benefit far into the future. At an annual crediting rate of just 4%, an extra $1,000 in taxes paid today would have been worth more than $2,000 in 20 years if that money had stayed in your account. Pay extra taxes on investment income for a couple decades and by the time you reach retirement, you're talking about some real money, like another year or two of "college tuition." Further, **the most costly opportunity costs are the ones that begin accruing today, not 20 years from now. The most profitable tax savings will be the ones you secure today.**

But solving the investment tax problem is probably not going to be as simple as throwing more money in your 401(k). If you have household taxable income at the $450,000 threshold, attempting to save 15 to 20% of gross income works out to somewhere in the neighborhood of $60,000 to $90,000 a year; even if both spouses are working, those numbers exceed the maximum 401(k) contribution limits. This means some allocations will use non-qualified financial instruments, and the selection process will not be as easy as checking a box on the company retirement plan's annual enrollment form. The discussion will include terms like tax-efficient, tax-favored, tax-deferred, and tax-free. To minimize your investment income tax burden, you'll want expert input, both in selecting products and understanding the tax ramifications.

Ben Franklin said the only two certainties in life were death and taxes. He's probably right; one way or another, governments will assess taxes. But strategic allocation and product selection can go a long way toward making sure taxes won't be the death of your wealth aspirations as well.

Giving It Away
(But a form is required)

For most of us, accum-ulating financial assets isn't an end in itself. Rather, we accumulate assets as a means to realize other material benefits. In the present, accumulating financial assets may give us a greater sense of financial security; we don't have to worry about paying for an auto repair, unexpected medical bill, or home maintenance issue. Over time, our accumulated assets may extend that sense of security into the future, providing for retirement and leaving an inheritance. Along the way, accumulated assets can be spent for our enjoyment: to go on vacations, obtain luxuries and engage in other pleasurable activities.

During a lifetime, some of our accumulated wealth may be used for the benefit of others; we may give assets to children or grandchildren, friends, and organizations we support. Giving while we are still alive allows us to see the impact of our generosity, and in some cases, it may help ensure that the gift is applied in accordance with our wishes (such as funding the college education of a grandchild today instead of leaving an inheritance to a spendthrift child).

Giving may also be financially advantageous in preserving wealth for future generations. If you're a business owner, professional, or otherwise have concerns about exposure of your assets to creditors, you may be able to shield these assets by giving them to family members today. In a similar vein, assets transferred at a low valuation today may result in lower future estate tax calculations than if the assets had remained in your estate.

The essence of giving is simple: what once was mine is now yours. But for a variety of reasons (financial and legal), the government also takes an interest in our gift-giving, even to the point of assessing taxes on certain gifts. And because government is involved, the specifics and paperwork of giving can be complicated. However, an understanding of basic gift-giving concepts can make it possible for most people to give effectively and maximize the enjoyment from their gifts. The following section provides a broad overview of the Federal Gift Tax regulations.

Note: Property laws vary from state to state, particularly laws involving spouses and joint owners, and almost every gift will have some transfer stipulations – how to title the account, when transfer occurs, etc. And because some gifts may be deemed fraudulent conveyances or attempts to circumvent the law, most gift transactions are subject to some form of legal review. Those issues should be discussed with competent legal professionals.

Unrestricted Gifts

There are several types of gifts that do not trigger a gift tax calculation. They are:

– Gifts to a spouse.
– Charitable gifts.
– Gifts to political organizations.

- Gifts of educational expenses – as long they are paid directly to the educational institution. (The exemption applies only to tuition. Books, supplies and living expenses do not qualify.)
- Gifts of medical expenses. Like educational gifts, they must be paid directly to the medical care provider.

The Annual Exclusion

Each year, an individual may gift a limited amount to as many individuals as he/she chooses without triggering the gift tax. This is known as the annual exclusion. The amount is indexed each year for inflation, and **for 2013, the annual gift exclusion is $14,000.** Considering the size of gifts some people may want to give, the $14,000 exclusion may seem low. But because of the wording of the exclusion, it is possible to gift quite a bit without exceeding the annual exclusion, particularly in family situations.

Because the exclusion applies to an individual, a husband and wife could each give their adult son $14,000 for a total of $28,000. If the son is married, the couple could also give their daughter-in-law another $28,000. Add a couple of grandchildren (at $28,000 each), and the parents could transfer $128,000 to their son's family without exceeding the annual exclusion. In some multi-generational financial plans, systematic gifting that stays within the annual exclusion limits can play a prominent role.

The Lifetime Exclusion

In addition to the annual exclusion, the Internal Revenue Code and Treasury regulations allow individuals to gift a specific amount of assets over their lifetime. This number is also the amount that can be excluded for estate tax purposes at death. The current lifetime gift tax exclusion is $5.25 million per person. As an interesting variation on the concept of unlimited giving to spouses, widows and widowers can receive any unused lifetime exclusion from a deceased spouse. And similar to the "double giving" that couples are allowed under the annual exclusion, this enables them together to transfer up to $10.5 million tax-free, either during their lifetime or when the estate is assessed at the death of the surviving spouse.

Here's an example to illustrate where the lifetime gift exclusion might come into play:

Suppose a husband and wife own a vacation property in a resort community. The property is currently valued at $1.5 million. Their only son and his family (his wife, and their three children) use the vacation home regularly, and the son has expressed an interest in keeping the property after his parents pass. Last month, a developer announced plans for an exclusive golf and residential community on land adjacent to the family home. This project promises to greatly inflate the values of existing homes, perhaps doubling or tripling their values.

The couple realizes it might be better to give their son title to the vacation home today, at a market value of $1.5 million, rather than waiting to transfer it at their death, when the value might be much higher. Later this year, they plan to give him the vacation home. From a gift tax standpoint, here's what will happen:

The couple can give a total of $140,000 of the home's market value using their annual exclusion (2 parents x 5 children/grandchildren x $14,000). The remaining $1.36 million ($1.5 million - $140,000) can be applied to the couple's lifetime exclusion. Divided equally, this means each individual's lifetime exclusion is now $4.57 million ($5.25 million - $680,000).

Reporting ongoing use of the lifetime exclusion

The IRS requires the reporting of gifts that exceed the annual exclusion and eat into the lifetime exclusion. Form 709 – The United States Gift (and Generation-Skipping Transfer) Tax Return – is a 5-page form that registers not only the gift, but how its value was determined, along with a history of previous gifts, and whether this gift is being reported on another Form 709 (each Gift Tax Return is filed ***individually*** – there are no joint Gift Tax Returns). If a gift results in a tax liability, it is usually the responsibility of the donor to pay it, although under certain arrangements, the IRS will allow the recipient to pay the tax.

Under the right circumstances, gifting financial assets can be a huge benefit for both the donor and the recipients. But between the legal and tax requirements, gifting is serious business.

Maximizing Cash Value Accumulation with Paid-up Additions

When investors seek financial instruments that promise both a specified rate of return and no loss of principal they are looking for "accumulation insurance." They want financial certainty, and will forgo alternatives that present potentially higher, non-guaranteed returns. While the usual suspects for the guaranteed portion of a portfolio are certificates of deposit and high-quality bonds, cash value life insurance products should also merit consideration.

Similar to a mutual fund, ownership of a cash value life insurance policy allows an individual to participate fractionally in a larger investment portfolio. The investment portfolios of most life insurance companies are heavily weighted toward high-grade bonds and similar conservative debt investments. A mutual fund holding a comparable portfolio of conservative assets might produce similar returns, but neither the share price nor returns would be guaranteed. In contrast, a standard whole life policy will offer constantly adjusted guarantees for both principal and earnings.

The excess earnings paid to the owner of a cash value life insurance policy are characterized as dividends and expressed as a crediting rate. For whole life versions of cash value life insurance, dividend rates are usually declared annually. The dividend rate reflects not only the performance of the insurance company's investment portfolio, but also profits realized through favorable mortality experience and lower administrative costs. Because dividends can be affected by issues other than investment performance, the crediting rate for dividends will not always mimic market rates for conservative financial instruments. However, the crediting rate will usually correlate to broader trends; if interest rates go up, the insurance company's annual crediting rates may rise as well.

While dividends are not guaranteed, highly-rated life insurance companies have a long history of paying dividends every year. And once the crediting rate is declared, it applies for the duration of the dividend period. Policy owners can track the dividend histories of their policies, and studies have shown the historical investment performance of life insurance cash values compares favorably with returns from high-quality bond portfolios.

Life insurance policies provide tax-free accumulation; unlike certificates of deposit or bonds held in a non-qualified account, annual cash value dividend distributions are not subject to tax (as income or capital gains) as long as they remain in the cash value account. In later years, the cash values may be configured to provide income, by taking either irregular or systematic withdrawals. Cash values can even be transferred to an annuity to provide guaranteed lifetime payments. Upon distribution, any gains from the cash values will be taxed as regular income, but the amount of tax due will depend on the manner in which funds are withdrawn.

While a typical permanent life insurance policy allows liberal access to cash values as either loans or partial surrenders, some contractual restrictions and tax issues may apply. In addition, a portion of the deposits to the contract (i.e., premiums) must also pay for the insurance benefit. While different policy features and premium formats can significantly increase or decrease cash value accumulations, contract holders must always account for the additional cost (and value) of the life insurance benefit when considering how a cash value insurance policy might fit in their larger financial picture. In order to have the advantages of a cash value account, you must buy a life insurance policy.

Given these parameters, financial experts have, in the past decade or so, begun to consider life insurance cash values as a unique asset class. Richard Weber, a principal with The Ethical Edge consulting firm, and co-author of a 2008 white paper on cash value life insurance, concluded that a combination of life insurance cash value with bonds delivered a higher return with lower risk compared with the all-bond portion of an individual's portfolio. Adds Weber:

> **"Investment managers should realize there may be a place for life insurance as part of the fixed income part of a portfolio. Fixed income investments have low correlations to stocks. Life insurance cash values don't move in the same direction (as stocks or bonds) during a crisis."**

Maximizing the insured accumulation features with Paid-Up Additions

Paid-up additions (PUAs) are small chunks of paid-up insurance attached to an existing whole life policy. PUAs add to both the insurance benefit and cash values. While typically acquired through dividends generated from regular premiums, many policies allow for the purchase of additional PUAs through the payment of unscheduled "extra" premiums. The amount that can be added as a PUA depends on the size and status of the base policy; if extra PUA premiums exceed IRS guidelines, the policy's tax status may be negatively impacted.

In a 2007 presentation, The Kugler Company, LLC explains how the unscheduled paid-up additions option allows policy owners to maximize the cash value accumulation features of a whole life policy. Kugler also reiterates a critical reminder: a portion of every premium and PUA deposit is allocated to pay the cost of the life insurance benefit; not every additional dollar deposited as a PUA is added to cash values.

However, when interest rates for guaranteed financial instruments are hovering between 1-2 percent, the 5-6% current dividend rates offered by some whole life policies may be a compelling reason to consider unscheduled PUAs as a way to accelerate your accumulations in a unique asset class that offers both security and access.

If you already own a whole life policy, now might be an opportune time to meet with your financial professional and determine if unscheduled Paid-up Additions would improve the performance of your insured accumulations.

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