Financial Briefs

Helping You Chart a Brighter Financial Future

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Hi Everyone!

Yes, this issue focuses heavily on taxes —again! And with good reason.

Key tax provisions are slated to soon expire, if no new legislation is adopted. So planning before year end is especially important to help you assess various potential moves and then choose the one with the greatest benefit for your circumstances. Give us a call if we can assist.

Warm regards,

Deidra

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Year-End Tax Planning--Special Concerns for 2010

Year-end tax planning is as much about 2011 as it is about 2010. Often, there's a real opportunity for year-end tax savings when you can predict that you'll be paying taxes at a lower rate in one year than in the other. For example, under the right circumstances, deferring a year-end bonus or potentially accelerating deductions into the current year can pay off in a big way. Of course, to effectively plan, it helps to have a good idea of what next year's tax rates will be. Unfortunately, as 2010 draws to a close, 2011 brings some uncertainty in that regard.

Will there be higher tax rates in 2011?

Currently, there are six marginal federal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. These brackets--the result of 2001 tax legislation--expire at the end of 2010. As things stand now, in 2011 the 10% bracket disappears, and the remaining brackets return to their pre-2001 levels: 15%, 28%, 31%, 36%, and 39.6%. Though it would take action by Congress, the president has indicated that he would like to permanently extend the 2010 rates for individuals earning less than $200,000 and married couples earning less than $250,000 (these dollar benchmarks would be reduced by an amount that reflected the standard deduction and exemption amounts), but allow the two highest brackets to return to 36% and 39.6% for higher earners.

What about long-term capital gains?

Currently, long-term capital gain is generally taxed at a maximum rate of 15%. If you're in the 10% or 15% marginal income tax bracket in 2010, though, a special 0% rate applies (in other words, you owe no tax on any long-term capital gain). The same rates apply to qualified dividends received in 2010.

These rates also expire at the end of the year. The maximum rate on long-term capital gain in 2011 will generally increase to 20%, with a 10% rate applying to individuals in the lowest tax bracket (special rules would apply to qualifying property held for five years or more). Qualifying dividends will be taxed as ordinary income. The president has proposed to permanently extend the 0% and 15% rates, with a new 20% rate applying to high-income individuals (those in the 36% and 39.6% tax brackets). Again, though, that all depends on what Congress does in the next few months.

Other considerations

- *2010 Roth IRA conversions:* A special rule applies to Roth IRA conversions in 2010 that allows you to postpone paying federal income tax on the income that results from the conversion. Instead of including the taxable income that results from the conversion on your 2010 federal income tax return (still an option if you so choose), you can report half the income on your 2011 return and half on your 2012 return. Whether a Roth conversion makes sense for you depends on your individual circumstances, including your marginal income tax rate in 2011 and 2012.
- *Alternative minimum tax (AMT):* In a now-familiar pattern, legislation that temporarily increased AMT exemption amounts, forestalling a dramatic increase in the number of individuals ensnared by the tax expired at the end of 2009. Congress is likely to act, but the specifics are uncertain.
- *Required minimum distributions (RMDs):* The requirement to take minimum distributions from IRAs and defined contribution plans was temporarily suspended for 2009; minimum distribution requirements are once again in effect for 2010.
- *Pending legislation:* Legislation is pending to extend some popular provisions that had expired, including the ability to deduct state and local sales tax in lieu of income tax on Schedule A, the additional standard deduction for state and local real property tax, and the above-the-line deduction for qualified tuition and related expenses. And additional legislation is likely, too, so stay up-to-date.

They're Baaack: RMDs for 2010

Required minimum distributions, often referred to as RMDs, are amounts the federal government requires you to withdraw annually from traditional IRAs and employer-sponsored retirement plans after you reach age 70½ (or, in some cases, after you retire). RMDs are also required if you inherit an IRA (traditional or Roth) or employer plan account. You can always withdraw more than the minimum amount from your IRA or plan in any year, but if you withdraw less than the required minimum, you'll be subject to a federal penalty tax equal to 50% of the shortfall.

In response to deteriorating economic conditions in 2008, Congress (as part of the Worker, Retiree, and Employer Recovery Act of 2008, or "WRERA") waived RMDs from IRAs and defined contribution employer plans for the 2009 calendar year. This allowed individuals to avoid having to deplete retirement plan assets while the value of those assets was suddenly depressed. But RMDs are back for 2010. Here's how the rules apply.

IRA owners and employer plan participants

If you turned 70½ before 2009, your RMD for the 2009 calendar year, which was due by December 31, 2009, was waived. You must now resume taking RMDs. Your next RMD (based on your December 31, 2009, account balance) must be taken no later than December 31, 2010.

As you can see, the 2009 waiver significantly complicates the RMD landscape for 2010. If you're taking RMDs from an IRA or employer-sponsored retirement plan, you may want to consider reviewing your situation with your financial professional.

If you turned 70½ in 2009, your first RMD (for the 2009 calendar year) was due by April 1, 2010. This RMD was waived. You must now take your first RMD (for the 2010 calendar year, based on your account value as of December 31, 2009) no later than December 31, 2010. You'll need to take your second RMD from the account (for the 2011 calendar year) no later than December 31, 2011.

If you turned 70½ in 2010, your RMDs are not impacted by the 2009 waiver at all. Your first RMD (for the 2010 calendar year) is due by April 1, 2011, and is based on the value of your account on December 31, 2009. You'll need to take a second RMD from the account no later than December 31, 2011.

Inherited accounts

In general, if you inherit an IRA (traditional or Roth) or employer-plan account, you must begin taking RMDs over your life expectancy ("life expectancy" rule) starting with the year following the year of the account owner's death. Alternatively, you may elect, or your plan may require, that you withdraw the entire account by December 31 of the calendar year containing the 5th anniversary of the account owner's death ("five-year" rule).

- Per the WRERA, if you inherited an IRA or employer account, and you were using the life expectancy payout rule, then your RMD for the 2009 calendar year was waived. You must take an RMD for the 2010 calendar year no later than December 31, 2010.
- If you inherited an IRA or employer account, and you were using the five-year rule for RMDs, you ignore 2009 when determining when your five-year period ends. So, for example, if your original five-year deadline was December 31, 2009, you ignore 2009 and you now have until December 31, 2010, to complete withdrawals from the account. Similarly, if your original five-year deadline was December 31, 2013, your new deadline, ignoring 2009, is December 31, 2014.
- If you inherited an employer plan account, you may have been given the right to elect whether to use the five-year rule or the lifetime expectancy payout rule for taking RMDs. This election is generally required no later than December 31 of the year following the year of the account owner's death. Per IRS Notice 2009-82, if your deadline for making the election was December 31, 2009, you now have until December 31, 2010, to make that election.
- If you inherited an employer account from someone other than your spouse, and the five-year rule applies to your benefit, you generally have until December 31 of the year following the year of the account owner's death to make a direct rollover of the account to an inherited IRA, and use the lifetime expectancy payout rule for distributions from the IRA. If the account owner died in 2008, you generally would have needed to complete your rollover by December 31, 2009. Per Notice 2009-82, you have until December 31, 2010, to complete the rollover.

As you can see, the 2009 waiver significantly complicates the RMD landscape for 2010. If you're taking RMDs from an IRA or employer-sponsored retirement plan, you may want to consider reviewing your situation with your financial professional.

Year-End Investment Planning Is More Challenging in 2010

If you don't normally review your investments at the end of each year, 2010 might be a good time to start. And if year-end investment planning is already part of your routine, you might want to pay special attention this year. Why? Because significant changes in the tax code that are scheduled to go into effect in 2011 could substantially alter the taxation of your portfolio next year. That could in turn affect your investment strategy. And since many expect additional changes that will affect next year's tax landscape, it's even more important than usual to think about whether your portfolio needs fine-tuning.

Begin planning before December 31

If you plan to sell a profitable investment at some point, you'll want to assess whether you should sell before the end of the year. That's especially true if you're in a low tax bracket or you have investments that have appreciated substantially. Investors in the 10% and 15% tax brackets currently owe no capital gains taxes on long-term capital gains. That is scheduled to change in 2011, when the long-term capital gains rate at this level is scheduled to increase from 0 to 10%. If you're in the 25% bracket or higher this year, you'll also need to think about this issue, though the scheduled increase from the current 15% to 20% isn't quite as dramatic as the leap from 0 to 10% that those in the lower income brackets will face. (Special, slightly lower rates for investments held for more than five years will apply beginning in 2011.)

Also, the tax brackets themselves are scheduled to change next year (see sidebar). If you plan to harvest a tax loss and think you may be in a higher tax bracket next year, it might make sense to first determine whether the loss would be more valuable later. Though tax considerations shouldn't be the sole factor in a decision to buy or sell, they shouldn't be ignored, either--especially this year.

Complicating your decisions, of course, is the uncertainty about whether the scheduled changes will undergo further revision before the end of the year. One possibility is to have a game plan based on the current scenario, and adjust it as warranted. It may seem like a burden, but for those in higher tax brackets, the extra effort could pay off come tax time.

Think about your overall tax burden

If you converted an IRA to a Roth IRA this year or are thinking about doing so before the end of the year, you may need to take that into account when deciding whether to book capital gains in 2010. That's because you're able to report the taxable ordinary income from the conversion on either your 2010 return or in the 2011 and 2012 tax years (half of the income in each year). Your decision about when you will account for the taxable income that results from a Roth conversion may affect your decision about the timing of investment sales, or vice versa. If you choose to report the income resulting from your Roth conversion on your 2010 return, consider whether it makes sense to realize sizable capital gains this year. If you feel it's to your advantage to sell assets and pay the capital gains tax in 2010, you may want to consider opting to postpone payment of the taxes owed on the Roth conversion until 2011 and 2012. That would mean the total taxes owed would be spread over three years rather than one (though as noted above, your future tax bracket also should be factored into the calculation).

Consider the tax status of dividends

Qualifying dividends are scheduled once again to be taxed next year as ordinary income, as they were before 2003, rather than at long-term capital gains rates, which are typically lower. If you'll be in the 15% tax bracket, that represents an increase of 15%. And if you'll be in the 28% tax bracket or higher next year, the change in the tax status of dividend payments could also have an impact; the higher your tax bracket in 2011, the greater the impact.

Don't forget the usual suspects

In addition to staying on top of the tax issues that complicate this year's investment planning efforts, there are some tasks that are useful every year. A portfolio review can tell you whether it's time to adjust your holdings to maintain an appropriate asset allocation. Also, if you have losses, you may be able to harvest those losing positions to offset some or all of any capital gains. Be sure to consider how long you've owned the asset; assets held a year or less generate short-term capital gains and are taxed as ordinary income.

If you're selling an investment but intend to repurchase it later, be careful not to buy within 30 days before or after a sale of the same security. Doing so would constitute a violation of the "wash sale" rule, and the tax loss would be disallowed. Finally, if you're considering the purchase of a mutual fund outside of a tax-advantaged account, find out when the fund will distribute dividends or capital gains, and consider postponing action until after that date to avoid owing tax on that distribution.

Federal tax brackets for ordinary income are scheduled to change in 2011 as follows:

10% becomes 15%

15% remains 15%

25% becomes 28%

28% becomes 31%

33% becomes 36%

35% becomes 39.6%

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This newsletter strives to provide factual and up-to-date information on the topics discussed, but it should not be regarded as a complete discussion of these issues. The reader is advised to engage the services of a competent professional before taking action on any subject matter discussed.

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Ask the Experts

What does a stronger dollar mean for my portfolio?

In the summer of 2008, investors were watching the dollar shrink. Because interest rates here were still relatively low, investors favored riskier investments that offered higher returns. The euro's value climbed to a record of almost $1.60 at one point. But with autumn came the crisis that shook the global financial system. Panicked investors suddenly decided that dollar-denominated assets such as U.S. Treasury bonds didn't look so wimpy after all. Within three months, a euro was worth 30 cents less. Worries about the European debt crisis and whether the euro would even survive as a currency has kept the dollar at roughly the same level or better for much of 2010.

What does that mean for your portfolio? The most obvious impact of a stronger dollar is on the value of overseas investments; the value of holdings denominated in a foreign currency will fluctuate with the exchange rate between that currency and the dollar. Some mutual funds that invest overseas attempt to hedge their currency exposure, using currency futures and other derivatives to try to limit the impact of that fluctuation on the fund's value. Others do not, hoping that any dollar weakness will increase the fund's value for U.S. investors.

Before investing in an international fund, check its prospectus, which is available from the fund. In addition to carefully considering its investment objectives, risks, fees, and expenses, don't forget the special risks of global investments, including political risks, currency risks, and different accounting standards; all of these can vary considerably by country and region. Also, find out whether the fund is hedged or unhedged. A falling dollar can enhance the returns of an unhedged fund, but the lack of a hedge leaves it unprotected if the dollar strengthens.

A stronger dollar can affect your portfolio even if you don't think you own any foreign investments. Many U.S.-based multinationals get a substantial percentage of their revenues overseas. A stronger dollar can cut into those revenues as U.S. exports become more expensive for overseas consumers. Also, many broad-based mutual funds include a percentage of overseas holdings among their assets.

Why should I care about Europe's debt problems?

When it became apparent last spring that Greece might be unable to make scheduled payments on its government bonds, equities plunged around the world. How is it possible for the debt of one country to have such a profound impact on investments in a 401(k) plan a continent away?

Investors were worried that Greece's problems with its budget deficit and level of sovereign debt (bonds issued by the national government) were emblematic of issues plaguing other eurozone countries--issues that could create global problems in economies with more global impact, such as Spain. For Europe, sovereign debt is the potential equivalent of the subprime mortgage market in the United States--the first domino that could spark major shocks to the banking industry and, by extension, the global financial system.

Concerns about the level of sovereign debt and the potential for default or restructuring of payments have already affected credit availability internationally; banks are conserving more capital, worried that they might need those reserves to cover any losses on their sovereign debt holdings. Global investors worry that tighter credit could slow a fragile global economic recovery or cause it to grind to a halt. European businesses and consumers that aren't able to buy U.S. exports could become a problem for U.S. corporations, many of which earn a substantial percentage of their revenues overseas.

Another concern is the stability of the euro itself. If stronger European economies lose the will to help bail out weaker countries, or if highly indebted countries are unable to make drastic and unpopular budget cuts, investors worry that the euro could be in peril. Equities hate uncertainty wherever it is, and the specter of chaos in the global financial system can affect markets worldwide. To combat these problems, European leaders have adopted many of the same steps taken in the United States during the 2008 financial crisis, such as establishing a massive lending facility and subjecting large banks to stress tests to determine their ability to withstand financial shocks.