Financial Briefs

Guidance For Every Stage of Life

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Hi Everyone,

As Election Day draws closer, folks have many considerations to weigh through.

Don't overlook the importance of assessing your potential tax impact headed into next year.

This issue highlights several major considerations that should be on most everyone's radar. Please give us a call if we can help you further in your year-end tax planning.

Warm regards,

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Fall 2012

Year-End Investment Planning and the Fiscal Cliffhanger

Four Retirement Planning Mistakes to Avoid

Withdrawals from Traditional IRAs

Can I be reimbursed from my health-care FSA for over-the-counter medications?

Year-End Investment Planning and the Fiscal Cliffhanger

Investment planning at the end of 2012 revisits issues that have complicated the planning process for the last two years--tax cut extensions and spending cuts designed to reduce the U.S. budget deficit. Uncertainty about both and whether they will lead to what's been called a "fiscal cliff" in 2013 is likely to affect year-end investment planning yet again.

Despite the uncertainties--or perhaps because of them--it might be worth starting early to look at various "what-if" scenarios in case you need to make last-minute changes to your portfolio. Even though you may not be sure of exactly what will happen in 2013, here are some factors to keep in mind as you plot your year-end strategy.

Review timing of your investment sales

As of January 1, tax brackets are scheduled to return to their pre-2001 levels. That means the current six tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) are scheduled to become five (15%, 28%, 31%, 36%, and 39.6%). Also, absent further changes, the maximum tax rate on long-term capital gains, currently at 15%, will increase to 20% (10% for those in the 15% tax bracket); those in the 10% or 15% marginal income tax bracket, who now pay a 0% rate on capital gains, will lose that special rate. Finally, qualified dividends, now taxed at a maximum of 15%, will once again be taxed at ordinary income tax rates.

Another factor for high-income individuals in 2013 is a new 3.8% Medicare contribution tax on some or all of the net investment income of individuals with a modified adjusted gross income over $200,000 ($250,000 for married couples filing jointly, and $125,000 for couples filing separately).

Ordinarily, higher rates in 2013 might suggest taking profits in an investment before those higher rates go into effect. However, the November election could affect the scheduled expiration date of those tax cuts, or even whether they expire at all. As a result, it's especially important this year not to let tax considerations be the sole factor in any investment decision. If you're uncertain about a sale, remember that another way to minimize capital gains taxes is to harvest investment losses that may offset gains.

Consider the potential economic impact of 2013

The nonpartisan Congressional Budget Office has warned that the tax increases and the roughly $109 billion in spending cuts could hamper an already sluggish economic recovery. Also, a 2% reduction in the Social Security portion of the payroll tax is scheduled to expire in January, leaving consumers with less to spend. Though there has already been talk about revisiting the spending cuts and tax cut expirations, you might want to consider how your portfolio might be affected.

Some companies are highly sensitive to economic cycles; others offer products and services that people need regardless of how the economy is doing and generally suffer less from a downturn (though any industry or company can have its own challenges). Also, the spending cuts could disproportionately affect some specific industries, such as defense, and companies that rely heavily on government contracts.

Interest rates and European instability

Partly because of the Federal Reserve's monetary policy and partly because of the European debt situation, interest rates have been at historic lows in recent months. This has meant higher prices for U.S. Treasury bonds, because bond yields move in the opposite direction from bond prices. However, investors who have relied on Treasuries for income and now want to roll over the proceeds of maturing bonds might be disappointed with available rates, which the Federal Reserve expects to remain low well into 2014. If that's the case for you, you may need to explore supplemental sources of investment income, or reexamine your Treasury holdings to see whether they now represent too much of your portfolio.

Even if you decide to wait and see what happens at year-end, planning for multiple scenarios now could help improve any last-minute decisions.

See disclaimer on final page

Four Retirement Planning Mistakes to Avoid

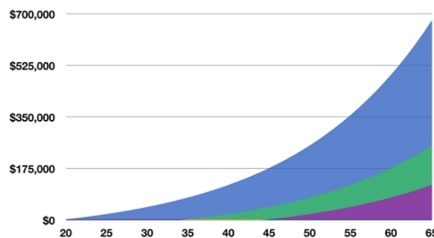
Because retirement may be many years away, it's easy to put off planning for it. The longer you wait, however, the harder it is to make up the difference later. That's because the sooner you start saving, the more time your investments have to grow.

We all recognize the importance of planning and saving for retirement, but too many of us fall victim to one or more common mistakes. Here are four easily avoidable mistakes that could prevent you from reaching your retirement goals.

1. Putting off planning and saving

Because retirement may be many years away, it's easy to put off planning for it. The longer you wait, however, the harder it is to make up the difference later. That's because the sooner you start saving, the more time your investments have to grow.

The chart below shows how much you could save by age 65 if you contribute $3,000 annually, starting at ages 20 ($679,500), 35 ($254,400), and 45 ($120,000). As you can see, a few years can make a big difference in how much you'll accumulate.



Note: *Assumes 6% annual growth, no tax, and reinvestment of all earnings. This is a hypothetical example and is not intended to reflect the actual performance of any investment.*

Don't make the mistake of promising yourself that you'll start saving for retirement as soon as you've bought a house or that new car, or after you've fully financed your child's education--it's important that you start saving as much as you can, as soon as you can.

2. Underestimating how much retirement income you'll need

One of the biggest retirement planning mistakes you can make is to underestimate the amount you'll need to accumulate by the time you retire. It's often repeated that you'll need 70% to 80% of your preretirement income after you retire. However, depending on your lifestyle and individual circumstances, it's not inconceivable that you may need to replace 100% or more of your preretirement income.

With the future of Social Security uncertain, and fewer and fewer people covered by traditional pension plans these days, your individual savings are more important than ever. Keep in mind that because people are living longer, healthier lives, your retirement dollars may need to last a long time. The average 65-year-old American can currently expect to live another 19.2 years (Source: National Vital Statistics Report, Volume 60, Number 4, January 2012). However, that's the average--many can expect to live longer, some much longer, lives.

In order to estimate how much you'll need to accumulate, you'll need to estimate the expenses you're likely to incur in retirement. Do you intend to travel? Will your mortgage be paid off? Might you have significant health-care expenses not covered by insurance or Medicare? Try thinking about your current expenses, and how they might change between now and the time you retire.

3. Ignoring tax-favored retirement plans

Probably the best way to accumulate funds for retirement is to take advantage of IRAs and employer retirement plans like 401(k)s, 403(b)s, and 457(b)s. The reason these plans are so important is that they combine the power of compounding with the benefit of tax deferred (and in some cases, tax free) growth. For most people, it makes sense to maximize contributions to these plans, whether it's on a pre-tax or after-tax (Roth) basis.

If your employer's plan has matching contributions, make sure you contribute at least enough to get the full company match. It's essentially free money. (Some plans may require that you work a certain number of years before you're vested in (i.e., before you own) employer matching contributions. Check with your plan administrator.)

4. Investing too conservatively

When you retire, you'll have to rely on your accumulated assets for income. To ensure a consistent and reliable flow of income for the rest of your lifetime, you must provide some safety for your principal. It's common for individuals approaching retirement to shift a portion of their investment portfolio to more secure income-producing investments, like bonds.

Unfortunately, safety comes at the price of reduced growth potential and the risk of erosion of value due to inflation. Safety at the expense of growth can be a critical mistake for those trying to build an adequate retirement nest egg. On the other hand, if you invest too heavily in growth investments, your risk is heightened. A financial professional can help you strike a reasonable balance between safety and growth.

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Withdrawals from Traditional IRAs

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Why you should think twice

Financial professionals generally recommend using your retirement funds for one purpose only--retirement. Why? Because frequent dips into your retirement funds will reduce your ultimate nest egg. Plus, there will be less money available to take advantage of the twin benefits of tax deferral and any compound earnings. Depleting your retirement funds too soon can create a dire situation in your later years.

And then there are taxes. If you've made only deductible contributions to your traditional IRA, then all the funds in your account are subject to federal income tax when you withdraw them. They may also be subject to state income tax. If you've made any nondeductible (after-tax) contributions to your IRA, then each withdrawal you make will consist of a pro-rata mix of taxable (your deductible contributions and any earnings in your account) and nontaxable (your nondeductible contributions) dollars.

All your traditional IRAs (including SEPs and SIMPLE IRAs) are treated as a single IRA when you calculate the taxable portion of a withdrawal. So you can't just transfer all your nondeductible contributions into a separate IRA, and then withdraw those funds tax free. And, if you're not yet age 59½, the taxable portion of your withdrawal may be subject to a 10% federal early distribution tax (your state may also apply a penalty tax).

10% early distribution penalty

To discourage early withdrawals from IRAs, federal law imposes a 10% tax on taxable distributions from IRAs prior to age 59½. Not all distributions before age 59½ are subject to this penalty, however. Here are the most important exceptions:

- Distributions due to a qualifying disability
- Distributions to your beneficiary after your death
- Distributions up to the amount of your tax-deductible medical expenses
- Qualified reservist distributions
- Distributions to pay first-time homebuyer expenses (up to $10,000 lifetime)
- Distributions to pay qualified higher education expenses
- Certain distributions while you're unemployed, up to the amount you paid for health insurance premiums
- Amounts levied by the IRS
- Distributions that qualify as a series of substantially equal periodic payments (SEPPs)

The SEPP exception to the early distribution penalty

The SEPP exception allows you to withdraw funds from your IRA for any reason, while avoiding the 10% penalty tax. But the rules are complex, and this option is not for everyone. SEPPs are amounts you withdraw from your IRA over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. You can take advantage of the SEPP exception at any age.

To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods and take at least one distribution annually. If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. You can also use tax-free rollovers to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas.

Even though SEPPs are initially determined based on lifetime payments, you can change--or even stop--the payments after five years, or after you reach age 59½, whichever is later. For example, you could start taking SEPPs from your IRA at age 50, without penalty, and then, if you no longer need the funds, reduce the payments (or stop them altogether) once you reach age 59½.

Short-term loan

If you only need funds for a short period of time you may be able to give yourself a short-term loan by withdrawing funds from your IRA, and then rolling those dollars back into the same or a different IRA within 60 days. However, watch the deadline carefully, because if you miss it, your short-term loan will instead be treated as a taxable distribution. And keep in mind that you can only make one rollover from a particular IRA to any other IRA in any 12-month period. A violation of this rule can also have serious adverse tax consequences.

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Can I be reimbursed from my health-care FSA for over-the-counter medications?

A health-care flexible spending account (FSA) allows you to pay for certain qualified medical and dental expenses with pretax dollars. With a health-care FSA, you can contribute pretax earnings to the plan (usually through a salary reduction agreement with your employer) and submit qualifying expenses to the plan for reimbursement. If you tend to spend a lot of money on medical expenses that are not covered by your health plan, contributing to an employer-sponsored health-care FSA is a good way to help pay for these expenses.

Although over-the-counter (OTC) medications used to be reimbursable from a health-care FSA, the Patient Protection and Affordable Care Act of 2010 amended the definition of qualified medical expenses for health-care FSA reimbursement purposes. As a result, OTC medications (except for insulin and medications that are prescribed by a physician) are no longer eligible for reimbursement.

However, many OTC medications are also available by prescription. You may want to ask your doctor for a prescription for any OTC medications that you use on a regular basis (e.g., pain relievers and allergy medications). You'll need to submit the prescription along with a receipt to your FSA provider in order to get reimbursed. Some FSA providers offer forms that allow your doctor to write a prescription once for any of the OTC medications that you'll need throughout the year.

Currently, there is no legal limit on the amount that you can contribute to a health-care FSA. However, most employers do impose a cap on contributions (typically $3,000 to $5,000). And beginning in 2013, if a health-care FSA is part of a cafeteria plan, annual contributions will be capped at $2,500 (starting in 2014, that amount will be adjusted for inflation).

Finally, when participating in an FSA, it's important to remember that you cannot carry over any money you contribute from one plan year to the next--in other words, if you don't use it, you lose it. As a result, it's important to choose your contribution amount carefully so that you don't risk losing any contributions at the end of the plan year.

Should I participate in my employer's wellness program?

Living a healthier lifestyle can greatly improve one's overall well-being and reduce health-care expenses. As a result, many employers are offering wellness programs to their employees as a way to reduce absenteeism and lower the cost of employer-sponsored health care. According to a 2010 Bureau of Labor Statistics survey, one-third of U.S. private sector workers had access to an employer-sponsored wellness program.

For employers, wellness programs not only reduce health-care costs by promoting healthier living, but they also have been shown to boost employee productivity and morale. The types of wellness programs vary among employers, but they typically cover a variety of healthy living issues, such as:

- Smoking cessation
- Exercise/physical fitness
- Weight loss
- Nutrition education
- Health screenings/assessments

Some companies even provide healthy living education, resources, and incentive tracking through an online "wellness portal."

In addition to helping you live a healthier lifestyle, a wellness program may offer financial benefits. Currently, employers are permitted to offer wellness incentives (e.g., premium discounts, cash rewards) to employees of up to 20% of the cost of their health-care premium. And beginning in 2014, under the 2010 Patient Protection and Affordable Care Act, employers will be able to increase the incentive amount to 30% of the cost of the employee's premium.

Keep in mind that with certain types of wellness incentives, such as cash bonuses or gift certificates, the value of the reward may be treated as taxable wages and therefore may be subject to payroll taxes.

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