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Hi Everyone,

As we enter the last quarter of the year, it's timely to review key aspects of your finances. Many folks are making employee benefit elections for next year. A new health care coverage option may be available for you through the new Affordable Care Act. And it's also time to review any estimated tax liabilities for the year.

Addressing these issues, among others, keeps you on top of your finances. Give us a call if we can help.

Warm regards,
Deidra

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October 2013

Financial Briefs

Guidance For Every Stage of Life

Plan Now for a Year-End Investment Review

You might not enjoy sitting down to do year-end investment planning, but at least this fall you can make plans with greater certainty. For the last three years, investment planning has meant trying to anticipate possible changes in tax law; for tax year 2013 and beyond, you know for sure how income, capital gains, and qualifying dividends will be taxed. That gives you an opportunity to fine-tune your long-term planning, or to develop a plan if you've postponed doing so. Here are some factors to keep in mind as the year winds down.

Consider harvesting your losses

With tax rates settled, the question of whether to sell losing positions to generate capital losses that can potentially be used to offset capital gains or $3,000 of your ordinary income becomes a much more straightforward decision. That process is known as harvesting tax losses, and it could prove especially worth considering this year. The first half of the year produced strong gains for U.S. equities; even a mediocre second half could still have the potential to leave you with a higher tax bill than you had anticipated.

To maximize your losses for tax purposes, you would sell shares that have lost the most, which would enable you to offset more gains. Unless you specify which shares of stock are to be sold, your broker will typically treat them as sold based on the FIFO (first in, first out) method, meaning that the first shares bought are considered to be the first shares sold. However, you can designate specific shares as the ones sold or direct your broker to use a different method, such as LIFO (last in, first out) or highest in, first out.

Interest rates: bane or blessing?

The Federal Reserve has said that if the economy continues to recover at its expected pace, it could raise its target Fed funds rate sometime in 2014. However, investors have been anticipating such an increase since early summer, when many bond mutual funds began seeing strong outflows from investors concerned that a rate increase could hurt the value of their holdings. As any consumer knows, lower demand for a product often means lower prices. And since bond prices move in the opposite direction from bond yields, yields on a variety of fixed-income investments have begun to rise. However, there also could be a silver lining for some investors. Higher yields could provide welcome relief for individuals who rely on their investments for income and have suffered from rock-bottom yields.

The Fed has said any rate decisions will depend on future economic data. However, now might be a good time to assess the value of any fixed-income investments you hold, and make sure you understand how your portfolio might respond to a future that could include higher interest rates. Many investors' asset allocation strategies were likely developed when conditions generally favored bonds, as they have for much of the last 20 years. Though asset allocation alone can't guarantee a profit or prevent the possibility of loss, make sure your asset allocation is still appropriate for your circumstances as well as the current investing climate. And don't forget that other financial assets can be affected by potential future interest rate changes as well.

Calculating cost basis for fixed-income investments

The IRS had originally planned to require brokers to begin reporting the cost basis for any sales of bonds and options this year, as it already does for stocks and mutual funds. It has now postponed implementation of the requirements for bonds until January 1, 2014 to give financial institutions more time to test their reporting systems. However, don't throw away your old records yet, especially if you're considering selling any of your bond holdings. The cost basis reporting requirements will apply only to bond purchases and options granted or acquired on or after January 1, 2014, so you'll still be responsible for calculating your cost basis for any bonds or options acquired before that date.

Stretch IRAs

The goal of a stretch IRA is to make sure your beneficiary can take distributions over the maximum period the RMD rules allow.

The term "stretch IRA" has become a popular way to refer to an IRA (either traditional or Roth) with provisions that make it easier to "stretch out" the time period that funds can stay in your IRA after your death, even over several generations. It's not a special IRA, and there's nothing dramatic about this "stretch" language. Any IRA can include stretch provisions, but not all do.

Why is "stretching" important?

Any earnings in an IRA grow tax deferred. Over time, this tax-deferred growth can help you accumulate significant retirement funds. If you're able to support yourself in retirement without the need to tap into your IRA, you may want to continue this tax-deferred growth for as long as possible. In fact, you may want your heirs to benefit--to the greatest extent possible--from this tax-deferred growth as well.

But funds can't stay in your IRA forever. Required minimum distribution (RMD) rules will apply after your death (for traditional IRAs, minimum distributions are also required during your lifetime after age 70½).

The goal of a stretch IRA is to make sure your beneficiary can take distributions over the maximum period the RMD rules allow. You'll want to check your IRA custodial or trust agreement carefully to make sure that it contains the following important stretch provisions.

Key stretch provision #1

The RMD rules let your beneficiary take distributions from an inherited IRA over a fixed period of time, based on your beneficiary's life expectancy. For example, if your beneficiary is age 20 in the year following your death, he or she can take payments over 63 additional years (special rules apply to spousal beneficiaries).

As you can see, this rule can keep your IRA funds growing tax deferred for a very long time. But even though the RMD rules allow your beneficiary to "stretch out" payments over his or her life expectancy, your particular IRA may not. For example, your IRA might require your beneficiary to take a lump-sum payment, or receive payments within 5 years after your death. If stretching payments out over time is important to you, make sure your IRA contract lets your beneficiary take payments over his or her life expectancy.

Key stretch provision #2

What happens if your beneficiary elects to take distributions over his or her life expectancy but dies a few years later, with funds still in the inherited IRA? This is where the IRA language becomes crucial.

If, as is commonly the case, the IRA language doesn't address what happens when your beneficiary dies, then the IRA balance is typically paid to your beneficiary's estate.

However, IRA providers are increasingly allowing an original beneficiary to name a successor beneficiary. In this case, when your original beneficiary dies, the successor beneficiary "steps into the shoes" of your original beneficiary and can continue to take RMDs over the original beneficiary's remaining distribution schedule.

When reviewing your IRA language, it's important to understand that a successor beneficiary is not the same as a contingent beneficiary. Most IRA providers allow you to name a contingent beneficiary. Your contingent beneficiary becomes entitled to your IRA proceeds only if your original beneficiary dies before you.

Stretch even further ...

If you name your spouse as beneficiary, your IRA can stretch even further. This is because your spouse can elect to treat your IRA as his or her own, or to transfer the IRA assets to his or her own IRA. Your spouse then becomes the owner of your IRA, rather than a beneficiary. As owner, your spouse won't have to start taking distributions from your traditional IRA until he or she reaches age 70½ (and no lifetime RMDs are required from your Roth IRA). Plus, your spouse can name a new beneficiary to continue receiving payments after he or she dies.

What if your IRA doesn't stretch?

If your IRA doesn't contain the appropriate stretch provisions, don't fret--you can always transfer your funds to an IRA that contains the desired language. In addition, upon your death, your beneficiary can transfer the IRA funds (in your name) directly to another IRA that has the appropriate stretch language.

A word of caution

While you might appreciate the value of tax-deferred growth, your beneficiary might prefer instant gratification. If so, there's little to prevent your beneficiary from simply taking a lump-sum distribution upon inheriting the IRA, rather than "stretching out" distributions over his or her life expectancy. It's possible, though, to name a trust as the beneficiary of your IRA to establish some control over how distributions will be taken after your death.

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Estate Planning and Income Tax Basis

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. When you make a gift of property, the recipient generally receives your basis in the property. When you transfer property at your death, the recipient generally receives a basis equal to the fair market value of the property. The difference can substantially affect the amount of taxable gain when the recipient sells the property.

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. This is because the income tax basis of the person receiving the property depends on whether the transfer is by gift or at death. This, in turn, affects the amount of taxable gain subject to income tax when the person sells the property.

What is income tax basis?

Income tax basis is the base figure you use when determining whether you have recognized capital gain or loss on the sale of property for income tax purposes. (Gain or loss on the sale of property equals the difference between your adjusted tax basis and the amount you realize upon the sale of the property.) When you purchase property, your basis is generally equal to the purchase price. However, there may be some adjustments made to basis.

What is the income tax basis for property you receive by gift?

When you receive a gift, you generally take the donor's basis in the property. (This is often referred to as a "carryover" or "transferred" basis.) The carried-over basis is increased--but not above fair market value (FMV)--by any gift tax paid that is attributable to appreciation in value of the gift (appreciation is equal to the excess of FMV over the donor's basis in the gift immediately before the gift). However, for purpose of determining loss on a subsequent sale, the carried-over basis cannot exceed the FMV of the property at the time of the gift.

Example: *Say your father gives you stock worth $1,000. He purchased the stock for $500. Assume the gift incurs no gift tax. Your basis in the stock, for the purpose of determining gain on the sale of the stock, is $500. If you sold the stock for $1,000, you would have gain of $500 ($1,000 received minus $500 basis).*

Now assume that the stock is only worth $200 at the time of the gift and you sell it for $200. Your basis in the stock, for purpose of determining gain on the sale of the stock, is still $500; but your basis for purpose of determining loss is $200. You do not pay tax on the sale of the stock. You do not recognize a loss either. In this case, your father should have sold the stock (and recognized the loss of $300--his basis of $500 minus $200 received) and then transferred the sales proceeds to you as a gift. (You are not permitted to transfer losses.)

What is the income tax basis for property you inherit?

When you inherit property, you generally receive an initial basis in property equal to the property's FMV. The FMV is established on the date of death or on an alternate valuation date six months after death. This is often referred to as a "stepped-up basis," since basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

Example: *Say your mother leaves you stock worth $1,000 at her death. She purchased the stock for $500. Your basis in the stock is a stepped-up basis of $1,000. If you sold the stock for $1,000, you would have no gain ($1,000 received minus $1,000 basis).*

Now assume that the stock is only worth $200 at the time of your mother's death. Your basis in the stock is a stepped-down basis of $200. If you sold the stock for more than $200, you would have gain.

Make gift now or transfer at death?

As the following example shows, income tax basis can be important when deciding whether to make gifts now or transfer property at your death.

Example: *You purchased land for $25,000. It is now worth $250,000. You give the property to your child (assume the gift incurs no gift tax), who then has a tax basis of $25,000. If your child sells the land for $250,000, your child would have taxable gain of $225,000 ($250,000 sales proceeds minus $25,000 basis).*

If, instead, you kept the land and transferred it to your child at your death when the land is worth $250,000, your child would have a tax basis of $250,000. If your child sells the land for $250,000, your child would have no taxable gain ($250,000 sales proceeds minus $250,000 basis).

In addition to income tax basis, you might consider the following questions:

- Will making gifts reduce your combined gift and estate taxes? For example, future appreciation on gifted property is removed from your gross estate for federal estate tax purposes.
- Does the recipient need a gift now or can it wait? How long would a recipient have to wait until your death?
- What are the marginal income tax rates of you and the recipient?
- Do you have other property or cash that you could give?
- Can you afford to make a gift now?

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Will interest rates rise this year?

The Fed hasn't yet raised its target interest rate from less than 0.25%, and it has promised not to do so before unemployment reaches roughly 6.5%, which it doesn't expect to happen until next year. However, some interest rates have already begun to go up. For example, according to Freddie Mac, the average interest rate on a 30-year fixed-rate mortgage shot above 4% last June for the first time since late 2011, hitting its highest level in almost 2 years. In the same month, the yield on the 10-year Treasury bond went above 2.5% for the first time since August 2011.

Why are interest rates rising even though the Fed's target rate hasn't? Because bond investors are concerned that higher interest rates in the future will hurt the value of bonds that pay today's lower rates. Immediately after the Fed's June announcement, investors began pulling money out of bond mutual funds in droves, reversing a multiyear trend. If there's less demand for bonds, yields have to rise to attract investors.

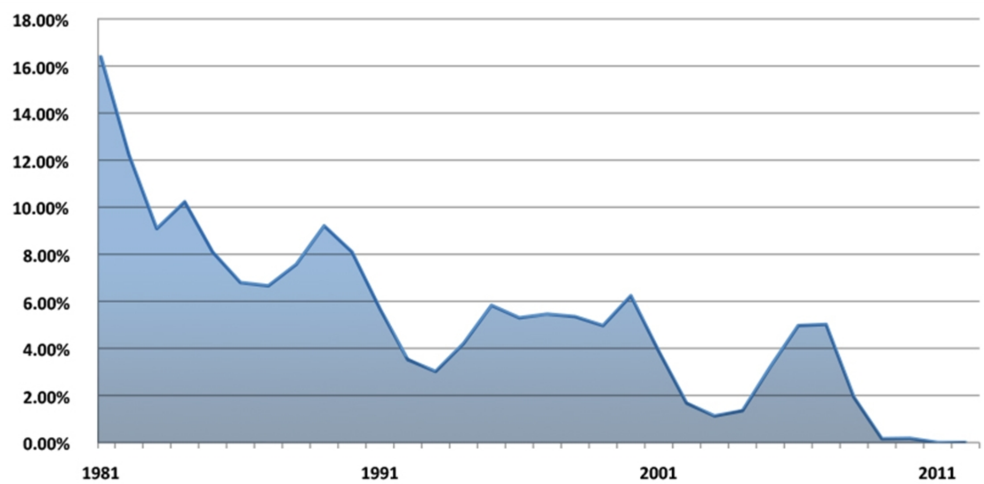
Aside from bonds, why are investors concerned about a possible Fed rate hike? Bonds aren't the only financial asset that can be affected by potential future interest rate changes. Dividend-paying stocks with hefty yields have benefitted in recent years; more competitive bond yields could start to reverse that dynamic. Shares of preferred stock typically behave much like those of bonds, since their dividend payments also are fixed; their values could be affected as well.

Also, higher mortgage rates could potentially slow the housing market recovery, though historically they remain at relatively low levels. And if a Fed rate increase were to bring on higher interest rates abroad, that could create even more problems in countries already struggling with sovereign debt--problems that have provoked global market volatility in the past.

The Fed has said any hikes in its target rate will occur only if the economy seems strong enough. If higher rates seem likely to halt the recovery, the Fed could postpone a rate hike even longer. It also will take other measures before raising rates. Even though the timing and size of any Fed action is uncertain, it's best to be aware of its potential impact.

Graph: Interest Rates 1981-2012

This graph represents the federal funds effective interest rate (the average rate at which banks lend to one another overnight), which has generally declined to historic lows over the 30-year period represented. Investment returns, as well as interest rates on bank loans and other fixed-income instruments, could potentially be affected when this rate rises.



Source: Board of Governors of the Federal Reserve System (www.federalreserve.gov), July 17, 2013