The
FINANCIAL UPDATE

DAY & ENNIS, LLC
FEE-ONLY FINANCIAL PLANNING

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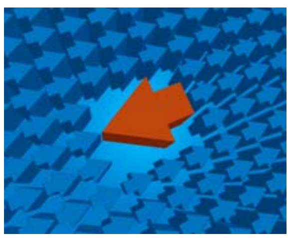
Year-End Tax Planning: Go Against The Grain?

For the first time in recent memory, year-end tax planning will feel like "Alice in Wonderland" in 2012. Many basic tax strategies won't make sense this year. Instead of the tried-and-true philosophy of accelerating deductions into the current year and deferring income to the next year, you may be inclined to do the exact opposite: defer deductions to 2013 and accelerate income into 2012.



The reason for this "Mad Hatter" approach is that federal income taxes are going up next year (barring any last-ditch legislation from Congress). Besides increases in ordinary income tax rates, the current rates for long-term capital gains and dividends also will be raised, effective January 1. In addition, certain high-income taxpayers will face a new 3.8% Medicare surtax on investment income, plus a new 0.9% surtax on wages, beginning in 2013.

Here are several year-end tax planning ideas for 2012 that defy conventional wisdom:

Capital gains. Usually, investors focus on harvesting tax losses from securities sales at year-end. Capital losses can offset capital gains, plus up to $3,000 of ordinary income, and any excess loss can be carried over to the following year. But this year you might emphasize harvesting capital gains, not losses. For 2012, the maximum tax rate on net long-term capital gain is 15% for high-income investors. That rate is scheduled to increase to 20% in 2013. The rate in 2012 for investors in lower brackets is 0%, and will jump to 10% or 15% in 2013.

State and local taxes. In the past, you may have prepaid state and local taxes due in January to increase your deduction for the current year. However, because deductions likely will be more valuable to you in 2013, when they will offset more highly taxed income, hold off on this strategy.

Charitable gifts. Similarly, a standard approach is to give gifts to charity in December, thereby increasing your charitable deduction for the current year. A donation made by credit card is deductible if it's made in December—even if you don't pay off the charge until January. However, you might decide to wait until next year to make large charitable gifts, when the tax write-off will be more beneficial.

Medical and dental expenses. This is a little trickier. For 2012, you can only deduct medical and dental expenses that exceed 7.5% of your adjusted gross income (AGI). But the AGI floor is being raised to 10% in 2013 for individuals under age 65. Basically, you should try to shift nonemergency expenses to the tax year in which you have the best chance at a deduction. If it's clear you'll surpass the 7.5%-of-AGI floor in 2012, by all means accelerate medical expenses into 2012. Otherwise, you might as well defer expenses to 2013.

Year-end bonuses. Normally, you would benefit from receiving a year-end bonus in January instead of

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Stephanie Davidson Becomes Day & Ennis Partner

It is our pleasure to announce that Stephanie Davidson will become a partner in our firm, effective December 31, 2012.

Stephanie has been a Senior Financial Planner with us since 2007 and was promoted to Operations Manager two years ago. She is a Certified Public Accountant and Certified Financial Planner®. Prior to joining Day & Ennis, she served for over 20 years as a Corporate Accountant at Blue Bird Corporation.

She is a Board Member and Treasurer of the Macon Volunteer Clinic, a member of the Macon Estate Planning Council, the Uptown Rotary Club, the Georgia Society of CPAs and the American Institute of CPAs. She is married to Brian Davidson and has two daughters, Erin and Kylee.

We appreciate the integrity and expertise that characterize all of Stephanie's efforts for Day & Ennis and welcome her involvement in shaping the future of our growing firm.

Which Funds To Tap In Retirement?

Unless you're independently wealthy, eventually you'll have to start using some of the money you've saved for retirement. After all, that's what it's there for, so there's nothing wrong with using those assets. But it could create problems if you spend the "wrong" funds first.

For purposes of deciding what to spend when, let's divide your retirement assets into three baskets: personal accounts, such as stock and bond holdings that are currently taxable; traditional IRAs and qualified retirement plans, such as a 401(k), income from which is typically taxed only when withdrawn during retirement; and non-taxable accounts, such as Roth IRAs.

The rule of thumb is to withdraw funds from your personal accounts first, your traditional IRAs and qualified plans second, and your Roth IRAs third. This spending order is likely to produce the lowest possible tax bill, promote more tax-deferred growth, and allow you to milk your assets for as long as possible. If you were to spend your money in the reverse order, you would pay more in taxes each year, thereby siphoning off funds that could have been reinvested and reducing your overall nest egg—and maybe even exhausting all your funds during your lifetime.

The preferred "spending order" in retirement is only reinforced by tax law changes scheduled to take effect in 2013. Barring last-ditch legislation, the tax brackets for individuals will be adjusted upward, with the current top tax rate of 35% being replaced by 39.6%. Furthermore, the maximum capital gains rate of 15% for most investors (0% for low-income investors) is increasing to 20% (10% for low-income investors). And qualified dividends, currently taxed at a rate no higher than 15%, will be taxable at ordinary income rates.

To add insult to injury for high-income investors, a new 3.8% Medicare surtax debuts in 2013. Under a special tax law provision, an investor must pay the 3.8% surtax on the lesser of "net investment income" or the amount by which modified adjusted gross income (MAGI) exceeds a threshold of $200,000 for single filers or $250,000 for joint filers. "Net investment income" includes most forms of taxable income, such as capital gains and dividends, but not distributions from qualified retirement plans and IRAs or tax-exempt income. Still, those items may increase your MAGI for this calculation.

Despite these tax-based incentives, remember that you generally have to begin taking "required minimum distributions" (RMDs) from qualified retirement plans and IRAs—but not from Roth IRAs—after age 70½. If you've reached that point, you may as well take the RMD amounts first before the regular sequence.

Last but not least: Everyone is different, so you may have valid reasons for changing the usual order. If you have any questions about your situation, please let us know.

Will Your Retirement Assets Last?

If you've been scrimping and saving for retirement, you may be hoping to relax when that red letter day finally arrives. But recent developments—such as rock-bottom interest rates on fixed investments, the threat of higher taxes, and economic uncertainty—might give you pause. Could you outlive your assets in retirement?

Perhaps. According to a study by the Employee Benefit Research Institute, about 44% of those born between 1948 and 1978—encompassing most Baby Boomers and those in Generation X—haven't adequately prepared for retirement. Here are six steps to protect you:

1. Set aside funds for fixed expenses. Consider how much of your retirement money will go for necessities such as food and housing, transportation, health care, and utility bills. Then try to squirrel away enough in safe but liquid assets to pay those costs for three to five years. If you have that kind of cushion, you won't have to cash out of your other investments during a downturn.

2. Live long and prosper. Medical advances and other trends are helping people live longer than they did just a generation ago, and you'll need to plan accordingly. One possible hedge is to acquire long-term care insurance to cover at least part of the cost of an extended stay in a nursing home. But these policies vary, so proceed with caution. Another idea is to purchase an annuity that can provide steady income through retirement.

3. Don't be overly conservative. Naturally, retirement isn't the time to speculate wildly in the stock market, but relying too much on more conservative investments such as bonds can be detrimental, too. Retirees looking for increased yield may opt for long-term bond funds, but be careful about locking into an investment that could backfire if interest rates start to

Who's Going To Pay The 3.8% Medicare Surtax?

Unless you've been stranded on a desert island, you've probably heard about the 3.8% Medicare surtax scheduled to take effect in 2013. This provision was included in the controversial health-care law—the Patient Protection and Affordable Care Act of 2010—upheld recently by the U.S. Supreme Court. Barring any late reprieve from Congress, investors will have to cope with this add-on tax for the foreseeable future.

How does it work? You must use a two-part test when you complete your tax return. The 3.8% Medicare surtax applies to the *lesser* of (1) "net investment income" or (2) the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount. Net investment income includes interest, dividends, royalties, rents, gains from selling property (other than property held in an active trade or business), and income from passive activities, but not tax-exempt interest or distributions from IRAs and qualified retirement plans.

For single tax filers, the threshold is $200,000; for joint filers, it's $250,000. The way the law is applied might result in an unexpected tax for some individuals, while others could escape unscathed. Here are six simplified examples:

Example 1. Alan is a single filer who each year earns $100,000 in wages and $50,000 of net investment income. Because his MAGI doesn't exceed the $200,000 level, Alan doesn't have to worry about the 3.8% Medicare surtax. It applies to investment income only if MAGI goes beyond the threshold.

Example 2. Barbara is a single filer who is retired. She has no wages and her entire MAGI comes from $225,000 of net investment income. Barbara does have to pay the 3.8% surtax on the MAGI part, even though she has no wages, because her $25,000 that exceeds the threshold is less than her investment income of $225,000. Her bill for the Medicare surtax is $950 (3.8% of $25,000).

Example 3. Charles and Donna, a married couple, are joint filers. They earn a total of $300,000 in wages, but have no net investment income. As a result, the couple doesn't have to pay the 3.8% Medicare tax, even though their MAGI exceeds the threshold for joint filers by $50,000. Their net investment income, which is the lesser of the two applicable amounts, is zero.

Example 4. Edward and Florence, a married couple, are joint filers. They earn a total of $200,000 in wages and have $150,000 of net investment income. Their $350,000 MAGI exceeds the threshold of $250,000 by $100,000. Because that's less than their investment income, it's their excess MAGI that is subject to the Medicare surtax. The couple must pay $3,800 (3.8% of $100,000).

Example 5. Gerard is a single filer who is retired. He has no wages and $200,000 of net investment income in 2013, but he also will receive a "required minimum distribution" (RMD) from his IRA of $125,000. The RMD doesn't add to his investment income, because IRA distributions don't count as investment income for the purposes of computing the Medicare surtax. But the money from his retirement plan does increase Gerard's MAGI to $325,000. The $125,000 by which that amount exceeds the $200,000 threshold is less than his $200,000 of investment income, so his surtax is calculated on the $125,000—leaving Gerard with a Medicare surtax of $4,750 (3.8% of $125,000).

Example 6. Hillary is a single filer who is retired. She has no wages and each year receives $100,000 in tax-exempt interest from municipal bonds, a $200,000 RMD from her IRA, and a $300,000 RMD from her 401(k) plan. As a result, none of the annual income that Hillary receives is treated as net investment income. She doesn't have to pay the 3.8% Medicare because her net investment income is zero, which is lower than the $300,000 by which her MAGI exceeds the $200,000 threshold. (Tax-free interest also doesn't count toward MAGI.)

Note that the 3.8% Medicare surtax also applies to trusts and estates. In those cases, the threshold for single or joint filers is replaced by the dollar figure at which the top tax rate for trusts and estates begins ($11,650 in 2012). That means that if all of the trust income is net investment income and the undistributed net investment income exceeds the dollar threshold by, say, $100,000, the trust must pay a Medicare surtax of $3,800 (3.8% of $100,000).

Are you among the unfortunate ones who will have to pay the 3.8% Medicare surtax? Don't just sit back and wait for it to happen. With advance planning, you may be able to reduce your MAGI or your net investment income—or both—to help offset the impact of the surtax. ●

rise. Consider intermediate bond funds to complement your portfolio.

4. Remember the "i" word. Although inflation hasn't reared its ugly head in recent years, most financial analysts say it's only a question of when, not if, it will return in a big way. Take inflation projections into account when figuring out how much you'll need to sustain you through retirement.

5. Diversify your portfolio. Stock market volatility can be a nightmare for retirees living on fixed incomes. To keep your portfolio on a steadier course, follow the basic investment principle of diversification. And because overcompensating with ultraconservative investments may do more harm than good, seek alternatives that match up well with fixed-income investments and equities.

6. Reduce the tax bite. Although tax planning is especially difficult now, learn to adapt to changing rules and conditions. For instance, it may be sensible to convert savings from a traditional IRA to a Roth to secure future tax-free payouts. ●

Don't Forget The 'Other' Surtax

In the wake of the Supreme Court ruling upholding the constitutionality of the 2010 health-care law, much of the focus has shifted to the 3.8% Medicare surtax that will apply to some high-income investors beginning in 2013. And this is with good reason. Those who are in the top 39.6% tax bracket then may pay an effective federal rate of as much as 43.4% on a portion of their investment income. Add in state taxes, and the new levy could be truly painful.

Yet there's another new Medicare surtax that hasn't received much attention. Beginning in 2013, you will have to pay an extra 0.9% tax on "earned income" which exceeds an annual threshold—$200,000 for single filers and $250,000 for joint filers. It's a relatively straightforward calculation—unlike the larger new surtax, which depends on how much income you receive from your investments as well as your overall earnings.

And while this additional new tax may seem small, it comes on top of the 3.8% Medicare surtax, plus your regular federal and state income tax liability. What's more, if your income is high enough, you might owe this tax year in and year out. It really can add up.

Take the example of a single filer who earns $500,000 a year. Starting in 2013, this person will have to pay an extra 0.9% surtax on the $300,000 that exceeds the $200,000 threshold, or $2,700 (0.9% of $300,000). Now assume that the figures stay the same for the next 10 years. As a result, this taxpayer will have to fork over a total of $27,000 (10 years x $2,700).

For the purpose of calculating the surtax, you can rely on the usual IRS definition of "earned income," which includes the following:

- Wages, salaries, tips, and other taxable employee earnings,
- Union strike benefits,
- Long-term disability benefits received prior to minimum retirement age,
- Net earnings from self-employment if you own or operate a business or if you're a minister or member of a religious order,
- Gross income received as a statutory employee.
- On the other hand, the IRS says the following items are not included under its definition of earned income:
- Pay received for work while an inmate in a penal institution,
- Interest and dividends,
- Retirement income,
- Social Security benefits,
- Unemployment benefits,
- Alimony,
- Child support.

Finally, business owners don't have to fret about doubling up on the surtax. The 0.9% levy applies only to employees who exceed the income threshold, not to the business entity that provides their salaries. At least that's a small consolation if you're stuck with this extra tax liability. ●

Go Against The Grain?

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December. That effectively enables you to defer tax on the bonus for another year. However, with tax rates increasing in 2013, high-income employees might arrange to receive an annual bonus before January, so that it likely will be taxed at a lower rate.

Self-employed income. In the same vein, if you're self-employed, you can accelerate income into 2012 by invoicing earlier in the year, instead of waiting until late December or January. Any extra income you receive this year will be taxed at the current rates rather than the higher rates scheduled to take effect in 2013.

Mortgage interest. One common year-end strategy for homeowners is to pay the mortgage installment due on January 1 of the following year in December of the current year. The idea is to increase your mortgage interest deduction by making a13th mortgage payment during the year. But unless you expect 2013 to be a low-income year, you may want to bypass this strategy in 2012.

Roth IRA conversions. If you convert a traditional IRA to a Roth IRA, you must pay tax at ordinary income rates on the value of the converted assets on the conversion date. Assuming a conversion otherwise makes sense for your situation, you might benefit from making the switch in 2012 instead of 2013 to reduce the tax hit, even though that means you have to pay the tax sooner. Alternatively, you could begin a series of partial conversions that take your projected top tax brackets for future years into account.

These are just a few ideas to consider. Of course, the year-end tax moves you make, or don't make, depend on your personal situation and the guidance of your tax advisor. ●

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