

# The FINANCIAL UPDATE

**DAY & ENNIS, LLC**  
FEE-ONLY FINANCIAL PLANNING



Second Quarter 2014

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## Identifying Investment Risk And Coping With It

**A**re you a risk-taker? To realize rewards, you usually have to take some risks, especially when it comes to finances. But beyond understanding that investment risk and reward go hand in hand, it's important to know how they relate. What is the nature of risk, and how can you handle the different kinds of risk that could affect the performance of your investments?

**What is the nature of risk?** For many investors, risk is associated with the inherent volatility of the equities markets. You run the risk that your investments will perform worse this year than last year or worse than you anticipated or worse than the markets as a whole.

Risk means you have something to lose—the money you've put into a particular investment or the money you might have made if you had made different choices. You also could run the risk of throwing good money after bad, of buying more of something when the price is low only to see the value fall further.

Although risk and reward are related, there's no direct, predictable connection between the two. You could decide to take fewer risks and still lose money, or you might ratchet up your investment risk without cashing in on higher returns. Nevertheless, it's important to try to keep risk and reward in a balance that fits your situation.

**What are the main types of risks?** Financial experts often debate

this question, but the pros generally agree that two significant risks facing investors are inflation and emotion.

**1. Inflation risk.** Essentially, this is the risk that money you earn will lose some of its purchasing power over

time. For example, if you buy a five-year certificate of deposit (CD) from a reputable bank, there's relatively little risk that the bank won't live up to the terms of the CD. But there's a much

bigger risk that the dollars you receive in five years won't buy as much as they would now.

If you're old enough to have experienced the 1980s, you might recall the days when money market funds paid interest at double-digit percentage rates. However, with double-digit inflation occurring at the same time, most savers barely stayed even.

Inflation risk can present problems to all investors, and especially to retirees. Someone who left work in 1978 might have felt pretty comfortable with a pension paying \$40,000 a year. But that \$40,000 was worth only about \$12,200 in 2013, according to the Bureau of Labor Statistics. This represents a loss of almost three-quarters of the money's buying power.

One way to protect against inflation risk is to include an appropriate ratio of stocks and stock funds in your portfolio. Or, if you're more conservative, you might consider

## When Can I Afford To Retire?

**T**his is one of the most frequent questions we hear from prospective clients. The answer may depend upon how many years you prepare for retirement before you begin making withdrawals.

The probability that you will meet your financial goals and maintain your standard of living is something we can calculate for you. If our analysis reveals any stumbling blocks to reaching retirement in your time frame, we can discuss alternative strategies. We can also help you avoid costly pitfalls in your preparation.

It's all part of the comprehensive financial planning process we offer our clients. We address everything from cash flow and retirement planning to investment strategy. You also benefit from income tax planning, insurance and risk management planning, estate tax planning, and education planning.

We do not sell any products or take any commissions, so you can rest assured that you are getting unbiased financial advice. We are fiduciaries, and are happy to coordinate our services with those of your CPA and attorney.

Feel free to call us at (478) 474-7480 to schedule a consultation, and plan to retire comfortably.

Sincerely,  
Day & Ennis, LLC

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# Beware The NII Surtax On Trusts

**T**ax experts have warned that the new 3.8% Medicare surtax—which applies to “net investment income” (NII)—can be a formidable tax obstacle for upper-income investors. But the NII tax isn’t just a concern for individual taxpayers. It also may affect trusts and estates. In fact, the overall impact on estates and trusts with substantial annual income might be even greater than the tax sting felt by wealthy individuals.

First, let’s review the basic rules. For 2013 and thereafter, you must pay the 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—\$200,000 for single filers and \$250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from trading financial instruments or commodities. However, certain items—such as wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions

from IRA and qualified retirement plans—are excluded from the definition of NII.

But the 3.8% Medicare surtax also applies to trusts and estates. In this case, the dollar threshold for single or joint filers is replaced by the dollar figure that begins the top tax rate for

figures or higher. Going back to our previous example, if the trust’s NII exceeds the upper limit of the top tax bracket by \$100,000, the surtax amounts to \$3,800 (3.8% of \$100,000), on top of the regular income tax.

What can you do about it?

Depending on the terms of the trust, you might be able to arrange for distributions to family members in lower tax brackets during years when the 3.8% surtax is minimal or nonexistent for the trust. For example, suppose that you’ve established a trust to pay for a grandchild’s college education and the grandchild is currently in the 10% tax bracket. By paying out distributions over several years while

the grandchild is still in the 10% bracket, you might sidestep a hefty NII surtax on the trust when he or she is ready to enter school.

Of course, there are other factors to consider, so this strategy isn’t for everyone. But don’t ignore the potential tax erosion for a trust if it continues to pile up investment earnings. ●



trusts and estates. For example, if all of the trust income is NII and the undistributed net investment income exceeds the dollar threshold by \$10,000, the trust must pay a Medicare surtax of \$380 (3.8% of \$10,000).

As you might imagine, the tax cost can become pretty steep for a trust with an annual income of five

# Count On The Portability Provision

**T**hough it’s still true that you can’t take it with you, a recent tax law change makes it easier to reduce or eliminate estate tax liability for your heirs. Thanks to a “portability” provision that’s now part of the law, any unused portion of the individual exemption from federal estate tax that isn’t used by the estate of the first spouse to die may be claimed by the surviving spouse’s estate.

This special estate tax break, first enacted in 2010, was set to expire after 2012. However, the American Taxpayer Relief Act (ATRA) extended it for 2013 and thereafter. Barring drastic change, you can count on

portability for the foreseeable future.

Under ATRA, the federal estate tax exemption is locked in at a generous \$5 million that is increased annually to account for inflation. (The exemption for 2014 is \$5.34 million.) As a result, a couple in 2014 can transfer up to \$10.68 million without incurring a dime of federal estate tax.

Suppose a husband owns \$4 million on his own, his wife has \$3.5 million, and they hold \$2.5 million in both their names—jointly with rights of survivorship, in legal jargon. Each spouse’s will leaves his or her entire estate to the other spouse and, upon the death of that

spouse, to the couple’s children.

Now suppose that the husband dies first in 2014. Because all of his individually owned assets pass to his wife, his estate needn’t use any part of his federal estate tax exemption. (Spouses normally can inherit an unlimited amount from each other without estate taxes.) So the wife now owns all of the couple’s assets, worth a total of \$10 million. When she dies, that \$10 million in assets goes to the couple’s children. Without portability, the wife would have only her own exemption, and that would leave her estate responsible for estate taxes on \$4.66 million (the \$10 million in assets

# Entering The Twilight Zone—Of Taxation

**R**od Serling, creator of the classic science-fiction TV series, “The Twilight Zone,” could not have come up with a stranger tax structure. You have entered a five-dimensional tax zone, a tax labyrinth so strange it almost seems like science fiction.

There’s more to the federal income tax system than just a single calculation. In fact, upper-income taxpayers—especially those generating income from investments—actually must cope with five “dimensions” of taxation: (1) ordinary income tax; (2) capital gains and losses; (3) the alternative minimum tax; (4) the net investment income tax; and (5) a reduction of itemized deductions and personal exemptions. Here’s a quick rundown:

**1. Ordinary income tax.** This is the standard tax calculation we’re all familiar with. The income you earn generally is taxed under a graduated rate structure with seven tax brackets: 10%; 15%; 25%; 28%; 33%; 35%; and 39.6%. If you’re in the top tax bracket, any extra income you earn is taxed at the 39.6% rate. Tax deductions and credits can be used to offset your tax liability based on these ordinary income rates, but certain special rules may apply (see #5).

Furthermore, under the “kiddie tax,” if investment income of a dependent child exceeds an annual threshold (\$2,000 in 2014), the excess generally is taxed at the

minus her \$5.34 million exemption). At the current 40% estate tax rate, the estate would owe more than \$1.8 million—money that wouldn’t go to the children. With portability, however, the combined exemption of \$10.68 million more than covers the \$10 million in the estate, and the heirs pay no estate tax.

As beneficial as the portability provision can be, it won’t necessarily solve every potential estate-planning



top tax rate of the parents. This can hike the overall family tax bill.

**2. Capital gains and losses.** The tax law provides separate tax treatment for capital assets such as securities and real estate. Generally, gains and losses from capital assets are used to offset each other. Long-term gains from assets held longer than a year qualify for a maximum 15% tax rate, but the rate increases to 20% for those in the top two ordinary income tax brackets. Qualified dividends also benefit from these preferential tax rates.

In addition, you can use excess capital losses to offset up to \$3,000 of ordinary income, and you can carry additional losses over to next year. With that in mind, “harvesting” losses is a common year-end tax strategy.

**3. Alternative minimum tax.** The alternative minimum tax (AMT) runs on a track parallel to ordinary income tax. This complex calculation involves certain additions and adjustments before subtracting an exemption amount based on your tax filing status. However, the exemption is reduced for high-income earners. There are just two tax brackets—26% and 28%—for taxpayers with AMT liability.

At tax return time, you compare your ordinary income tax result to the AMT result and effectively pay the higher of the two. This “alternative” tax often catches unwary taxpayers

problem. For example, it still might be a good idea to establish a bypass trust, a tool that, before portability, could be used to maximize the estate tax exemptions of married couples. Although no longer needed for that purpose, a bypass trust still could be used to protect assets from creditors, guard against other tax consequences, such as the generation-skipping tax, and be especially helpful in allocating assets when one or more spouse has children from a previous marriage. ●

by surprise.

## **4. Net investment income tax.**

The “net investment income” (NII) tax is a new wrinkle that taxpayers have to deal with for the 2013 tax year and beyond. You must pay a 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—\$200,000 for single filers and \$250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. But some items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans, are excluded from the definition.

The NII tax is an add-on to the ordinary income tax calculation. Thus, your combined top tax rate can be as high as 43.4%!

## **5. Reduction of itemized deductions and personal exemptions.**

Two tax law provisions that were reinstated in 2013 may affect upper-income taxpayers adversely. Under the “Pease rule” (named for the congressman who originated it), certain itemized deductions, including those for charitable donations, state income tax, and mortgage interest, are reduced if your adjusted gross income (AGI) exceeds an annual threshold. For 2014, the threshold is \$254,200 of AGI for single filers and \$305,050 for joint filers. The total of your itemized deductions covered by the Pease rule is reduced by 3% of the amount above the AGI threshold, but not by more than 80% overall.

A similar rule phases out the tax benefit of personal exemptions. Under the personal exemption phaseout (PEP) rule, exemptions are reduced by 2% for each \$2,500 (or portion thereof) of your AGI that exceeds an annual threshold. The PEP thresholds are the same as those for the Pease rule.

Beyond these five, a sixth dimension exists for most taxpayers—state income taxes. ●

# Is It Too Late For Roth Conversion?

**W**hen you're creating a retirement paycheck from a blend of Social Security, pensions, and personal retirement accounts, it only makes sense to do what you can to minimize income and investment taxes. For example, consider the distributions from your traditional IRAs or 401(k)s. Most or all of that income will be taxed at full income rates that now go as high as 39.6%. In contrast, under most circumstances, withdrawals from Roth IRAs aren't taxed at all. So should you switch from traditional IRAs to a Roth? Or is it too late to benefit from such a conversion?

The answer depends on your situation. Because you'll have to pay income tax on the money you convert to a Roth IRA, one crucial calculation involves whether your federal income tax bracket will be higher or lower during retirement. It usually makes sense to convert before retirement if you expect to be in a higher tax bracket later, while if you anticipate being in a lower bracket in retirement, you probably should wait until then to convert. If you are retired and expect to

remain in a relatively low tax bracket, you might decide not to convert at all.

The main attraction of a Roth IRA for retirees is the lure of tax-free payouts while living on a fixed income.

Distributions you take after age 59½ from a Roth you've had for at least five years will be exempt from federal income tax.

And, from an estate planning view, with a Roth you won't be subject to the mandatory lifetime distributions that traditional IRAs require. But because a Roth conversion is taxable, it's like taking money out of an IRA for almost any other reason—and it may or may not pay off.

**Example 1:** You're in the 39.6% tax bracket now, you expect to be in the 28% bracket in retirement, and you have \$500,000 in an IRA. If you convert to a Roth this year, you'll have to pay a tax of \$198,000. That's probably not worth the future benefit of receiving tax-free payouts—money

that would have been taxed at the 28% rate without the conversion. However, if you wait until you drop into the 28% bracket, the conversion will cost less and may be worthwhile.

## **Example 2:**

You're in the 28% bracket now, you expect to be in the 39.6% bracket during retirement, and you have \$100,000 in an IRA. If you convert to

a Roth this year, you'll pay a tax of at least \$28,000. (It may be higher because part of the conversion could be taxed at a 33% rate.) But that may be preferable to being taxed on that money at the top 39.6% rate during retirement.

You'll also need to weigh other factors, including the size of your account and whether a series of smaller conversions might reduce your overall tax liability. Also, a Roth conversion effectively could increase the 3.8% surtax on your net investment income. We can help you figure out the best strategy for your situation. ●



## Identifying Investment Risk

*(Continued from page 1)*

inflation-protection bonds. History has shown, however, that holding even a modest equity stake may increase returns without undue risk when compared to a pure fixed-income portfolio.

**2. Emotional risk.** It's easy to let emotions rule decision-making. Almost everyone is subject to bouts of fear and greed, and investors have an innate tendency to be overconfident about their ability to choose winning positions. But simply doing what feels right—or avoiding what feels wrong—can lead to adverse results.

Consider an investor who sits on the sidelines during a bull market, nervous about following the crowd—a

tendency that indeed can be counterproductive. But finally the investor gets tired of losing out and jumps in, buying at the top of the market and without carefully considering the fundamentals of particular investments. Others get into trouble when the market is falling and they sell solid holdings in a panic, losing out on the chance to benefit when they rebound.

The best protection against emotion is to have a carefully considered investment plan and to try to stick with it even when markets are highly volatile. Having a balance of bond funds for stability and income and stocks for growth can help smooth out inevitable market bumps.

### **How do you manage risk?**

Everybody has a different risk

tolerance. A good approach for managing yours is to stick to investment fundamentals. That may be as simple as refocusing on the key principles of diversification and asset allocation.

Diversification spreads your investments over a broad mix of asset classes, an approach that has the potential to reduce risk. Asset allocation is the process of assigning percentages to those asset classes based on your particular needs and risk tolerance, and then rebalancing your holdings regularly to keep them close to their assigned allotments.

There's no way to avoid risk completely, but you still can generate earnings while staying within your comfort zone. We're here to provide guidance. ●