VESTPOINTEWEALTH
MANAGEMENT
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Second Quarter 2013

New Law Poses Tax Risks For High-Income Investors

It will take time for investors to absorb exactly what happened—and what did *not* happen—in the new tax law enacted to avert the "fiscal cliff." Under the new law, called the American Taxpayer Relief Act (ATRA), favorable tax rates on different types of investment income generally were preserved, but certain upper-income investors will face tax increases, beginning in 2013.

When you combine the ATRA changes with the new 3.8% Medicare surtax—also making its debut in 2013—you could be hit with a rate as high as 43.4% on a portion of your investment income.

Consider the following three main new tax law provisions:

1. Ordinary income. The existing federal income tax rate structure—with rates of 10%, 15%, 25%, 28%, 33%, and 35%—continues for most taxpayers. But ATRA adds a new top tax of 39.6% for single filers with income of more than $400,000 and joint filers with income above $450,000. That means that a short-term capital gain on the sale of a stock you've owned for a year or less—a profit taxed at ordinary income rates—could trigger the 39.6% federal rate.

2. Capital gains and qualified dividends. Under ATRA, the maximum tax rate for net long-term capital gains and qualified dividends remains 15% (0% for investors in the lowest tax bracket). If the law hadn't passed, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket), and dividends were scheduled to be taxed at ordinary income rates. Despite the reprieve for most investors, however, those who exceed those same high-income thresholds—$400,000 for single filers and $450,000 for joint filers—now will pay a maximum 20% tax rate on long-term capital gains and qualified dividends.

3. Medicare surtax. This "add-on" tax actually was included in the 2010 health care legislation—the Patient Protection and Affordable Care Act—rather than ATRA. But it also takes effect in 2013, and it can be just as lethal to upper-income investors as some ATRA changes. A 3.8% Medicare surtax now will apply to the lesser of "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount—$200,000 for single filers and $250,000 for joint filers. These figures will not be indexed for inflation.

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. Certain items are excluded from the NII definition, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans and IRAs.

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Old Strategy For A New Environment

As the stock market hits all-time highs this year, we revisit a particular strategy that can make a lot of sense. The strategy is to fund charitable contributions with appreciated investments. While this strategy often can involve a fair amount of legwork, there is a way to minimize the hassle of administering the gift of an investment.

Donor advised funds (DAF) are charitable organizations that are available through various avenues such as community foundations or brokerages. DAFs allow investors to establish giving accounts and contribute assets.

The DAFs ultimately sell the investments without tax consequences to the donors. The donors later designate which charities will receive the proceeds of the investments. The contributions can be funded with appreciated investments such as stocks or mutual funds. In doing so, taxes are avoided on the gains inherent in the investments.

If the investors are concerned about maintaining their investment positions, then cash can be added to the portfolios to purchase the investments that were given away.

There also are other intangible benefits when establishing donor advised funds. For investors who regularly make charitable contributions and have appreciated assets, this strategy is a perfect fit!

If you are interested in this strategy and would like more detail, please feel free to contact us.

When Do You Need An Appraisal?

Are you planning to donate real estate to charity? The tax law allows you to claim deductions, within generous limits, for giving property to qualified charitable organizations. But you have to meet strict requirements, including the necessity to obtain an independent appraisal for property valued at more than $5,000.

In fact, in a new case, a taxpayer who donated real estate worth approximately $18 million failed to provide the required appraisal, and after an audit, the IRS challenged his charitable deductions. The Tax Court's verdict? His deduction was zero!

The basic rules for deducting gifts of property say you can't use those donations to write off more than 30% of your adjusted gross income (AGI). Overall, your charitable deductions can't exceed 50% of your AGI for the year. But if you exceed those levels, you can deduct the rest in future tax years.

If you donate property that has gained value, the deductible amount is equal to the fair market value (FMV) of the property at the time of the donation, as long as you've owned it for more than one year. For shorter-term gifts of property, the deduction is limited to your "basis" (usually, what you paid for it).

However, the IRS requires you to jump through a few hoops before you can pocket any tax deductions. When you file your tax return, you must include a detailed description and other information for property valued at more than $500. Also, if you claim the FMV is more than $5,000, you must obtain a written appraisal of its worth.

In the case of the above disallowed deduction, Mr. Mohamed was a prominent entrepreneur, real estate broker, and certified real estate appraiser. He donated several parcels of property to a charitable remainder trust during a two-year period. When he completed his tax returns for those two years, he attached Form 8283 (Noncash Charitable Contributions). Based on his own appraisals, the total FMV of the properties exceeded $14 million (although his initial deduction was "only" $3.8 million due to the AGI limits).

But Mohamed didn't read the form's instructions explaining that self-appraisals aren't permitted. He also omitted important information such as the basis of the properties. The IRS challenged the deductions. When Mohamed appealed to the Tax Court, the IRS disallowed the entire deduction, despite subsequent independent appraisals establishing the total FMV at more than $18 million. In the end, the Tax Court agreed with the IRS, although it acknowledged the result was harsh.

The moral of this story is that if you donate appreciated property, you need to make sure you observe the strict letter of the law. ●

Find Extra Benefits In DI Insurance

The odds that you'll suffer a disabling injury or illness are far greater than the likelihood of you dying prematurely. A disability income (DI) insurance policy, used to supplement life insurance coverage, could help protect you from loss of income if you're unable to work. Indeed, a DI insurance policy might provide even more benefits than you expect.

Typically, a private DI insurance policy can pick up some of the slack if you're disabled for an extended time. Should you no longer be able to work, you will begin receiving a monthly disability benefit. Normally, the benefit is a predetermined amount, unlike employer-provided coverage, in which the benefit equals a percentage of compensation.

As with life insurance, DI terms can vary widely from policy to policy. Some key variables include the amount of the benefits you'll receive; the length of the coverage; the requirements for receiving full benefits; the definition of "disability"; the length of the waiting period before benefits begin; any cost-of-living adjustments; availability of partial benefits; and possible non-cancellation features. Naturally, the cost of the premiums also will vary, depending mainly on those variables.

But don't assume that you must be bedridden to collect any benefits. Frequently, a DI insurance policy will provide "residual benefits" in the event you can work some of the time or if you're slowly getting back on your feet. Some policies even offer benefits after you've returned to work if you are earning less than you did before your disability.

The residual benefits generally kick in when the loss of income is greater than 20% of previous earnings and the decline is due to the medical condition underlying the disability. This feature could be especially

Weigh The Key Factors For A Roth Conversion

Ever since the Roth IRA was introduced—way back in 1998—financial planners have been bombarded with questions about this retirement planning tool. Can I covert a traditional IRA to a Roth? If I can, should I? And if it is a good idea, when should I convert?

There's no blanket answer to all of those questions. To a great extent, the decision to convert or not will depend on your particular circumstances. Still, there are several key factors for you to weigh, and general guidelines based on the current tax landscape.

If you have a traditional IRA, all of the distributions you receive (to the extent that they represent deductible contributions and earnings) will be taxed at ordinary income rates. Beginning in 2013, the top tax rate on ordinary income was raised from 35% to 39.6%. In addition, a 3.8% Medicare surtax now applies to the lesser of your "net investment income" (NII) or the amount of your modified adjusted gross income (MAGI) that exceeds $200,000 for single filers and $250,000 for joint filers. Although IRA distributions don't count as NII for the surtax calculation, they can still boost your annual MAGI. As a result, you might pay an effective federal income tax rate of 43.4% on all or part of your IRA distributions.

In contrast, qualified distributions from a Roth IRA that you've had for at least five years are 100% tax-free. For these purposes, "qualified distributions" include those you take after you reach age 59½; because of death or disability; or that are used for first-time homebuyer expenses (up to a lifetime limit of $10,000). For instance, if you convert a traditional IRA with $1 million in assets to a Roth IRA at age 55, you can withdraw the entire $1 million, plus any earnings, at age 60 without paying a dime in additional federal income tax. (You will already have been taxed on the amount you converted to the Roth.)

Another important distinction is that you must begin taking required minimum distributions (RMDs) from a traditional IRA after reaching age 70½; in contrast, there are no mandatory lifetime RMDs with a Roth. This can be a crucial advantage if you won't need IRA funds in retirement.

It used to be that you couldn't convert to a Roth in a year in which your MAGI exceeded $100,000. But that barrier was removed in 2010, so conversions are now available to all retirement savers.

The main stumbling block is that a conversion is taxable at ordinary income rates just as if you had withdrawn the amount as a regular distribution. That means you need to examine at least four key factors in the conversion decision.

1. The tax rate differential. Compare your current tax rate with the tax rate bracket you expect to be in when you withdraw funds from your IRA in retirement. The lower your current rate as compared to the expected retirement rate, the greater the incentive to convert now. Conversely, you may not want to convert if your current rate is much higher than your expected rate during retirement.

2. Availability of non-IRA funds. One frequently overlooked Roth conversion question involves whether you have funds on hand to pay a significant conversion tax. If you'll be forced to siphon funds from your IRA to pay the tax bill, you're diluting the future benefit of a conversion. But a conversion now could make sense if you have money in other accounts to cover the resulting tax.

3. Funds you have to pay living expenses. Will you need to begin drawing down IRA funds within the next few years? If you have to tap a Roth right away, you may not realize the full benefit of the tax-free distributions. If you can keep your IRA intact for a longer period, a conversion may be more attractive.

4. Time horizon. A Roth conversion may appeal most to middle-aged investors who are still several years from retirement. If retirement is imminent or you're already retired, that may reduce your incentive to make a conversion. Nevertheless, switching to a Roth may still be reasonable if you're older, especially if you're looking for ways to preserve assets for your heirs.

Focusing on these four factors, crunch the numbers to see whether a Roth makes sense for your situation. One or more factors may count more heavily for you than others do, and we can help you do a detailed analysis.

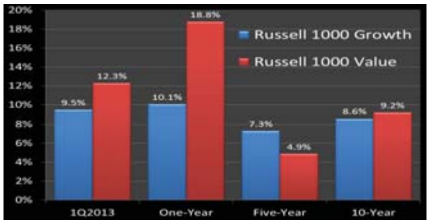
Finally: Don't worry about pulling the trigger on a conversion and then regretting your decision. You can "recharacterize" a Roth IRA as a traditional IRA if you make the decision in advance of the tax return due date (plus extensions) for the year of the conversion. ●

valuable to small business owners, including self-employed entrepreneurs, and professionals in fee-based practices, such as physicians, attorneys, and accountants.

For example, suppose a surgeon recovering from a severe illness returned to practice but was able to see fewer patients. If the surgeon's income was reduced from $50,000 a month to $30,000, the residual benefit could restore income to 80% of the pre-disability level—in this case, $40,000 a month. Similarly, if the side effects of chemotherapy make it too hard for a litigator to appear in court or for a CPA to handle a company's books, the residual benefits can soften the economic blow.

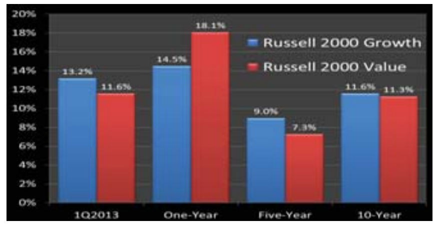
To see what your coverage may or may not include, take a close look at existing DI policies or any new policy you're considering and have your insurance agent explain the residual benefits section. The policy might be more valuable than you imagined or the residual benefits may be too restrictive. Those provisions could be a key component of your DI insurance coverage. ●

Market Data Bank: 1st Quarter 2013 *Ψ



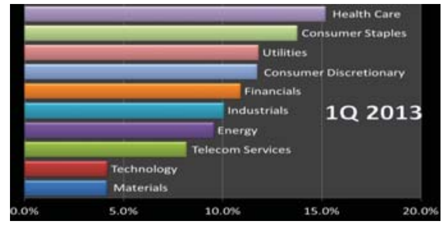
LARGE VALUE VS. LARGE GROWTH

1Q2013 was again a strong quarter for U.S. stocks. Stocks in the quarter returned what bulls hope for in a full year. The five-year total return shown encompasses the financial-crisis bear market and recovery through 1Q2013.



SMALL VALUE VS. SMALL GROWTH

Small-cap growth companies in the Russell 2000 index showed total return of 13.2% in 1Q2013, as the U.S. stock rally continued to confound skeptics. Bulls said a "great rotation" from bonds to stocks was under way.



LARGE-CAP STOCKS BY INDUSTRY

Tech companies, while a fascination, last quarter were among the weakest of the 10 industry indexes of S&P 500 companies. Consumer stocks were among top sectors; reflecting a recovery in consumer balance sheets.

ASSET CLASSES ±

Of 11 asset classes, commodities were by far the worst for the five years ended 3/31/2013, highlighting the risk of betting on any one asset class. The best asset class, as represented by these 11 stock and bond ETFs and indexes, was gold, which lost luster last quarter.

S&P 500 INDEX VS. EARNINGS¥

Estimated S&P 500 earnings per share as of March 21, 2013 was $112.21 for 2013 and $125.31 for 2014. If consumer spending holds and companies meet expectations, the trajectory of stock prices versus earnings is shown in the red squares in the chart above.

FOREIGN STOCK MARKETS

U.S. stocks outperformed stock markets of foreign regions across the world for the five years ended 3/31/2013. The period encompasses a bear market in 2008 and recovery through 1Q2013. The U.S. economy did show resilience versus foreign markets in the period.

ΨPast performance does not indicate future results. ±Indices and ETFs representing asset classes are unmanaged and not recommendations for any specific investment. Foreign investing involves special risks, including political or economic instability and currency fluctuation. Bonds offer a fixed rate of return while stocks fluctuate. ¥Actual S&P 500 index data through 3/31/2013 and actual earnings through 12/31/2012. Estimated 2013 and 2014 S&P 500 earnings per share as of March 21, 2013. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates; Standard and Poor's for index prices through 3/28/13 and actual earnings.

New Law Poses Tax Risks

(Continued from page 1)

Now let's see how these tax changes might affect taxes on investment income:

Example 1. You're a joint filer with an annual MAGI of $170,000 consisting mainly of wages. This puts you in the regular 28% tax bracket. At the end of the year, you realize short-term capital gains of $10,000 and long-term capital gains of $40,000, for a total of $50,000 in NII. Because you don't exceed the threshold for ordinary income, your short-term gains still are taxed at the 28% rate. And you don't exceed the threshold for capital gains either, so your long-term gains are taxed at the 15% rate. Finally, the lesser of your NII or excess MAGI is zero, so you don't have to pay the 3.8% Medicare surtax.

Example 2. You're a single filer with an annual MAGI of $500,000, consisting mainly of wages. This puts you in the new top tax bracket of 39.6%. At the end of the year, you realize short-term capital gains of $25,000 and long-term capital gains of $75,000, for a total of $100,000 in NII. Your short-term gains are taxed as ordinary income at the 39.6% rate. In addition, you exceed the threshold for capital gains, so your long-term gains are taxed at the 20% rate. Finally, the lesser of your NII or excess MAGI is $100,000, triggering a Medicare surtax of $3,800 on top of your other taxes.

Accordingly, the new tax rules could affect the rates you pay on investment income. And while taxes alone never should determine your investment decisions, it makes sense to factor them in when you're considering what and when to buy or sell. Depending on your situation, you might accelerate income or capital gains into the current year to avoid higher taxes next year, or you could postpone income or gains to next year to avoid higher taxes this year. We can work with your tax advisor to help you decide what makes sense in your situation. ●

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