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Happy April!

I hope all is well with each and everyone of you.

April 17th is tax filing deadline, please call if you have not scheduled your appointment. Due to April travel plans, I will soon be filing extensions for people, where we have not started work on the returns. Remember an extension allows you to legally file up until October 15th but still requires you to pay by April 17th!

Due to the rush of tax season, just one new posting on the website regarding Long Term Care. Keep those suggestions rolling in, I do appreciate them!

Thanks to everyone for their continued business and support.

April 2012

GARRETT PLANNING NETWORK

Election Year Tax Talk: Deciphering the Terminology

This year's election chatter is sure to include a healthy dose of tax talk. To keep up, here are five terms you should know.

The "Bush tax cuts"

A number of major tax changes were enacted in 2001 and 2003, including lower federal income tax rates, special maximum rates for long-term capital gains and qualifying dividends, and increased standard deduction amounts. While most of the provisions were extended by legislation passed in late 2010, these tax provisions are still commonly referred to as the "Bush tax cuts" or the "Bush-era tax cuts." With these provisions set to expire again at year-end, much of the tax debate will center around whether to extend the provisions again--particularly whether to extend the provisions for all taxpayers, or only to those who make less than a certain amount (e.g., individuals with incomes under $200,000, married couples with incomes under $250,000).

Alternative minimum tax (AMT)

The AMT is essentially a separate federal income tax system with its own rates and rules. If you're subject to the AMT, you have to calculate your taxes twice--once under the regular tax system and again under the AMT system. Bush tax cuts expanding AMT exemption amounts were extended only through the end of 2011. This increases the pressure to address AMT this year--failure to extend AMT relief would result in an estimated 30 million or more individuals being affected by the AMT in 2012. (Source: U.S. Congressional Research Service. The Alternative Minimum Tax for Individuals (RL30149; August 23, 2011), by Steven Maguire.)

The "Buffett rule"

On August 14, 2011, the *New York Times* published an opinion piece written by Warren Buffett, chairman and CEO of Berkshire Hathaway (Warren E. Buffett, "Stop Coddling the Super-Rich," *New York Times,* August 14, 2011). In the piece, Buffett essentially argued that he and his "mega-rich friends" weren't paying their fair share, noting that the rate at which he paid taxes (total tax as a percentage of taxable income) was lower than the other 20 people in his office. As Buffett points out, this is partially attributable to the fact that the ultra-wealthy typically receive a high proportion of their income from long-term capital gains and qualified dividends, which are currently taxed at rates that are generally lower than the rates that apply to wages and other ordinary income. President Obama has articulated the "Buffett rule" as the tenet that people making more than $1 million annually should not pay a smaller share of their income in taxes than middle-class families pay. (Source: www.whitehouse.gov.)

Value added tax (VAT)

A value added tax (VAT) is a consumption tax, like a sales tax. What distinguishes the VAT from a straight national sales tax is the fact that the VAT is assessed and collected at every point in the chain of production, on the "value added" at that step in the chain. Although a VAT can be implemented in different ways, here's one general approach: With a 10% VAT in effect, a supplier who sells $100 of materials to a manufacturer would pay $10 in VAT; the manufacturer who, in turn, sells a finished product to a retailer for $150 pays $5 in VAT ($150 sale price - $100 cost of materials, multiplied by the VAT rate); the retailer sells the product for $200, and pays an additional $5 in VAT ($200 sale price - $150 cost, multiplied by the VAT rate). Total VAT paid on the product is $20, or 10% of the final sale price.

Flat tax

Simple in concept, a flat tax would apply a single tax rate to individual income, or individual wages only (i.e., excluding investment income). A separate single rate might apply to businesses. Depending on the specific proposal, a base exemption may be allowed to exclude low-income families from the tax, and certain deductions may be allowed in determining the amount subject to tax.

Inheriting an IRA--What You Need to Know

The rules governing inherited IRAs can be complicated. If you inherit an IRA from someone who isn't your spouse, your options are fairly limited. If you inherit an IRA from your spouse, you have many more options.

The rules governing inherited IRAs can be complicated. Here are the major issues to consider.

Transferring inherited IRA assets

If you inherit a traditional or Roth IRA from someone who isn't your spouse, your options are fairly limited. You can't roll the proceeds over to your own IRA, treat the IRA as your own, or make any additional contributions to the IRA. What you can do is transfer the assets to a different IRA provider, as long as the registration of the account continues to reflect that the IRA is an inherited IRA, and not your own.

If you inherit an IRA from your spouse, however, you have additional options. You can roll over all or part of the IRA proceeds to your own IRA (or to a qualified plan). If you roll the proceeds over to your own IRA (an existing one, or one you establish just for this purpose) the rules that apply to IRA owners, not beneficiaries, will apply from that point on. If you're the sole beneficiary, you can also generally treat the inherited IRA as your own by simply retitling the IRA in your name.

But you aren't required to assume ownership of an IRA you inherit from your spouse. You can, instead, continue to maintain the inherited IRA as a beneficiary. You might want to do this if, for example, you inherit a traditional IRA and you'll need to use the funds before you turn 59½ (distributions from inherited IRAs aren't subject to the 10% early distribution penalty but distributions from IRAs you own are subject to the penalty, unless an exception applies).

A spouse beneficiary can also convert all or part of an inherited traditional IRA to a Roth IRA (you'll generally have to pay income tax on the amount converted). This option is not available to nonspouse beneficiaries.

Required minimum distributions

Nonspouse beneficiary: Federal law requires that you begin taking distributions (called required minimum distributions, or RMDs) from an inherited IRA (traditional or Roth) after the IRA owner dies.

Spouse beneficiary: If you roll the inherited IRA over to your own IRA, or treat it as your own, then the RMD rules apply to you the same way they apply to any IRA owner--you'll generally need to begin taking RMDs from a traditional IRA after you turn 70½; no lifetime RMDs are required at all from a Roth IRA. If you don't roll the IRA assets over or treat the IRA as your own, then the same rules described above for nonspouse beneficiaries generally apply to you, except that you can defer receiving distributions until your spouse would have turned 70½.

Note: *In both cases, if the IRA owner died after turning 70½ and didn't take a required distribution for the year of death, you'll need to make sure to take that distribution by December 31 of the year of death in order to avoid a 50% penalty.*

Taxation of inherited Roth IRAs

Qualified distributions to a beneficiary from an inherited Roth IRA are free from federal income taxes. To be qualified, the distribution must be made after a five-year holding period. The five-year period begins on January 1 of the year the deceased IRA owner first established *any* Roth IRA, and ends after five full calendar years. If you take a distribution from an inherited Roth IRA before this five-year period ends, any earnings you receive will be nonqualified, and will be subject to federal income taxes (earnings generally come out last).

For example, you inherit a Roth IRA from your father on January 1, 2013. Your father established this IRA in June 2012. Your father also established a separate Roth IRA, which you did not inherit, in December 2008. Distributions you receive from the Roth IRA will be qualified, and tax free, because the five-year holding period (January 1, 2008, to December 31, 2012) has been satisfied.

If you're a spouse beneficiary, and you roll the inherited Roth IRA over to your own Roth IRA or treat the inherited IRA as your own, then you'll be eligible to take tax-free distributions only after *you* reach age 59½, become disabled, or have qualifying first-time homebuyer expenses. You'll also need to satisfy the five-year holding period, but a special rule applies. The five-year period for all of your Roth IRAs--including the inherited IRA--will be deemed to have started on January 1 of the year either you or your spouse first established *any* Roth IRA.

Speak to a financial professional if ...

- You're sharing the inherited IRA with other beneficiaries. This can impact when and how you must begin receiving RMDs from the IRA.
- You don't want or need the IRA funds. You may be able to disclaim the IRA and have it pass to another beneficiary. This must be done in accordance with strict IRA rules.
- Any estate taxes were paid that are attributable to the inherited IRA. You may be entitled to an income tax deduction equal to the estate taxes paid.

Investing in a Low Interest Rate Environment

Don't stop at yield

If you're tempted to seek a higher return, don't forget that yield alone shouldn't be your only criterion. In reaching for additional yield, you may be taking on additional risk. Also, if and when interest rates rise, the change may affect a bond's market value unless held to maturity. Don't hesitate to get expert help to assess whether you can increase your return without taking on more risk than you can afford.

Low interest rates create a dilemma. Do you accept a low return because you feel you must protect your principal? Or do you take on greater investment risk in order to try for a higher return? Here are some factors to consider in trying to balance those two concerns.

Consider laddering CDs

When yields on Treasury bonds began dropping, many investors were attracted to bank certificates of deposit (CDs). However, interest rates won't stay low forever; at some point you may want access to your money before a CD matures. One way to potentially achieve higher rates while retaining some flexibility is to ladder CDs. Laddering involves investing in CDs with varying maturity dates. As the shorter-term CDs mature, the proceeds can be reinvested in one with a longer term, which may have a higher rate. Over time, laddering may provide both the higher rates typically offered by longer-term CDs, and the ability to adjust as rates change.

For example, let's say Harriet Hypothetical wants to invest $60,000 in CDs. She might put $20,000 in a one-year CD that pays 0.5%, another $20,000 in a three-year CD that pays 1.25%, and the final $20,000 in a five-year CD that pays 1.75%. When the one-year CD matures, she reinvests that money in another five-year CD. When her three-year CD matures, she reinvests it in still another five-year CD. At that point, funds from a maturing CD will be available every year or two, but will earn the higher five-year rate. If rates are lower when a CD matures, she has the option of investing elsewhere.

Pay attention to costs

Low returns magnify the impact of high investing expenses and taxes. Let's say a mutual fund has an expense ratio of 1.00, meaning that 1% of its net asset value each year is used to pay operating expenses such as management and marketing fees. That 1% represents a much bigger bite out of your return when the fund is earning 3% than it does if a fund is earning 10%. At the higher number, you're losing only about 10% of your return; at 3%, almost a third of your return goes to expenses. If you prefer individual stocks, keep an eye on trading costs.

Note: *Before investing in a mutual fund, carefully consider its fees and expenses as well as its investment objective and risks, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing.*

Think about your real return

Low interest rates may not be quite as problematic as they seem. Even if you're earning a low interest rate, your real return might not suffer too much if inflation is also low. Real return represents what your money earns once inflation is taken into account. With an annual inflation rate of 2.6%--the average over the past 20 years based on the Consumer Price Index--a bond that pays 3.5% would produce the same real return as a bond that pays 4.5% when inflation is 3.6% a year.

Compare interest rate and yield spreads

In general, long-term bonds pay a higher interest rate than bonds with a shorter term. However, the difference between long-term and short-term rates can change as investors assess changing economic conditions. For example, when it seems likely that interest rates will rise in the near future, investors often are reluctant to tie up their money in longer-dated maturities and gravitate to short-term debt. As short-term demand rises, the difference between the interest rates paid by different maturities can also increase.

The yields of various types of bonds can also change relative to one another. For example, when demand pushed U.S. Treasury yields to new lows in 2011, it widened the gap between Treasuries and corporate bonds. Such differences can create opportunities in one type of bond versus another.

Consider small changes

Your portfolio may not need a complete remake to seek a higher return. For example, if you're in Treasuries, you could move a portion of that money to municipal bonds. That might involve greater risk of default, but net returns might be boosted by the munis' exemption from federal income tax. Or a portion of your stock allocation could be shifted to dividend-oriented stocks, exchange-traded funds, or preferred stock.

Look for buying or selling opportunities

Interest rates also can be used to help evaluate equities. Some analysts like to determine the relative value of the stock market using the so-called Fed market valuation model. (Though not officially endorsed by the Federal Reserve Board, the method seems to have evolved based on a 1997 Fed report.) The model compares the earnings yield on the S&P 500 to the 10-year Treasury bond's yield. If the S&P's yield is higher, the market is considered undervalued. However, this is only one of many valuation models and shouldn't be the sole factor in an investing decision.

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Can I provide annuity payments to my heirs after I die?

You may be able to provide income payments to your heirs for the rest of their lives through the use of a stretch annuity. A stretch annuity (also known as a legacy annuity) makes lifetime payments to the beneficiary you name in your deferred annuity contract if you die before the annuity start date (e.g., before you begin receiving regular annuity payments).

According to the rules regarding distribution of deferred annuity death proceeds, an annuity beneficiary other than the surviving spouse must receive the annuity proceeds within one year from the date of death. Often, the beneficiary will elect to receive the proceeds in a lump sum, subjecting all of the annuity's accumulated interest to income tax, significantly reducing the value of the beneficiary's proceeds. A better option might be to allow the annuity's death benefit to be paid over a number of years, in which case only a portion of each payment is subject to income tax and the balance of the annuity can continue to grow tax deferred.

Generally, most annuity issuers allow the beneficiary to elect how the proceeds are to be distributed. However, some issuers allow the annuity owner to determine how the annuity's proceeds are to be distributed. In either case, in addition to the lump sum payment, most issuers allow the proceeds of a nonqualified annuity to be distributed:

- Over a period not to exceed 5 years
- Annuitized over a period no longer than the beneficiary's life expectancy, including a period certain, such as 10 years
- As scheduled withdrawals based on the beneficiary's life expectancy according to the IRS life expectancy table

A stretch annuity may be most appropriate:

- For beneficiaries in a high income tax bracket who would pay substantial income tax on annuity earnings if received in a lump sum
- For beneficiaries who may be spendthrifts and might be better served by receiving systematic payments as opposed to a large, lump sum of money

Can I deduct losses from my variable annuity?

Generally yes, if the annuity is a nonqualified (e.g., not an IRA) commercial annuity. Typically, a variable annuity allows you to invest your premium in various mutual funds, called subaccounts. Unfortunately, these subaccounts may not perform favorably, and your premium could actually decrease in value.

You can claim the deduction in the year you surrender, or cash-in, the annuity (a partial surrender can't be claimed as a deductible loss). The amount of the loss is determined by subtracting the cash surrender value of the annuity from your basis in the contract. The basis is your investment in the annuity, reduced by any prior withdrawals from principal. For income tax purposes, the loss is treated as an ordinary loss and not a long-term capital loss.

Unfortunately, the IRS has not provided definitive guidance as to where the loss should be claimed on your tax return. Some believe the loss should be taken on the front of Form 1040 as "other gains or losses" from Form 4797.

However, IRS Publication 575 (Pension and Annuity Income) treats the deduction of a variable annuity as an itemized miscellaneous deduction on Schedule A subject to the 2%-of-adjusted-gross-income limit.

Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk including the possibility of loss of principal. Variable annuities contain fees and charges including, but not limited to, mortality and expense risk charges, sales and surrender (early withdrawal) charges, administrative fees, and charges for optional benefits and riders.

Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity, or from your financial professional. You should read the prospectus carefully before you invest.

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