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Major Components of New Tax Law

On December 16, 2010, Congress approved $801 billion in tax cuts and $57 billion for extended unemployment insurance. The legislation included other tax breaks, such as a college tuition credit for some families, an expanded child tax credit, and an earned income tax credit. A few of the more notable tax impacts on you and your portfolio are listed below.

Social Security Tax: A one-year payroll tax cut reduces the Social Security tax to 4.2% from 6.2%. Although this was intended to increase consumer spending and stimulate the economy, if you are currently working, a better option may be to increase the contribution to your 401(k), 403(b), or 457 account if you can afford it from a cash flow perspective. The contribution limit for such accounts remains $16,500 for those under 50 years of age and $22,000 for those over 50.

Dividends/Capital Gains Tax Rates: Dividend and long-term capital gains taxes will remain at 15% for the next two years. Prior to the passage of the legislation, taxes on long-term capital gains were slated to increase to 20% beginning this year.

Estate Taxes: The new tax package set new estate tax parameters with an exemption of $5 million per person, or $10 million per couple, and a maximum tax rate of 35% for the next two years. If you have not done so already, you should consult with an estate planning attorney about creating an estate plan that will detail how your assets will be distributed after you pass away and who will act on your behalf should you become disabled.

COMPASS Wealth Management, LLC encourages you to speak with a tax professional regarding how this new tax law may impact your financial situation.

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Advisor Corner

I pride myself in offering you expert financial advice along with personalized service. Assisting you in reaching your financial goals is my business and I take that responsibility very seriously.

As an objective and independent fee-only wealth manager, my sole interest is to ensure my recommendations meet your financial goals.

COMPASS Wealth Management, LLC is a client-focused wealth management firm dedicated to providing superior advice to individuals, families, and corporate retirement plans.

Our wealth management services include investment management, retirement and gift planning, education funding, and other advisory services.

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Tax Tribulations

By Louis E. Conrad II

- Most taxpayers dread preparing their tax returns each year or even assembling the needed information if they use a tax preparer.
- This article highlights not only the complexity of the tax code, but also the attempts by some to scam taxpayers or file fraudulent tax returns.

As you finalize and perhaps agonize over the assembly of your tax-related documents and the preparation of your tax returns, now might be the perfect time to review the latest information on tax compliance, scams, and fraud.

Tax Compliance

According to the Taxpayer Advocate Service (TAS), an independent organization within the IRS created to help taxpayers resolve problems with the agency, the most critical issue confronting taxpayers is the federal tax code's complexity. TAS estimates that 6.1 billion hours are spent annually by individuals and businesses complying with the intricate web of tax code. Further, TAS believes more than 3 million full-time workers would be required just to comply with the tax code, equivalent to the workforce of one of the largest U.S. industries.

Exactly how long is the tax code? TAS concedes that even it doesn't know, but estimates that the federal tax code is 3.8 million words long, equivalent to 11,045 single-spaced pages. Not surprisingly then, roughly 60% of individual taxpayers pay a professional to prepare their tax returns and another 29% of tax filers purchase tax preparation software to do it themselves. Despite assistance from tax professionals and software, the IRS fielded 110 million calls in its most recent fiscal year.

TAS itself advocates for reform to reduce the tax code's complexity. TAS also believes that the IRS is challenged by its increasing role as a benefits administrator, not just a tax collector. Recent examples include the home buyer tax credit, the Making Work Pay credit, and forthcoming changes as a result of the health care reform law.

Tax Scams

The IRS has warned taxpayers about scammers who may contact them via e-mail, telephone, facsimile, or letter in an effort to obtain bank and investment account numbers, Social Security numbers, credit card and PIN numbers, and other confidential information to commit identity theft or steal money. Many of these schemes may appear valid initially due to the use of the IRS name and logo.

However, the IRS (1) does not ask for detailed personal and financial information, such as PINs and passwords that are used to gain access to accounts and (2) does not initiate communication with taxpayers through e-mail. If you receive such a "phishing" e-mail, the IRS suggests that you not reply to the e-mail or open any attachment or click on any link. In addition, the IRS asks that you forward the e-mail to the agency at phishing@irs.gov.

If you receive a telephone call, facsimile, or letter from someone claiming to be with the IRS and you suspect they are not, contact the IRS at (800) 829-1040 to determine if the IRS has a need to contact you. For other than phishing attempts, such as the misuse of the IRS name, logo, or forms, you are encouraged to contact the Treasury Inspector General for Tax Administration (TIGTA) at (800) 366-4484.

Tax Fraud

One example of tax fraud is that last year nearly 50,000 prison inmates claimed more than $130 million in tax refunds, or an average of $2,600 per claimant. These inmates did not supply any wage information to the IRS according to TIGTA, which issued a report on the matter. TIGTA, however, believes that the IRS should investigate further to determine the extent to which refunds were fraudulently claimed.

Fraudulent tax returns from inmates are part of a broader problem, however. During last year's tax filing season, the IRS identified almost 250,000 fraudulent tax returns, a 50% increase over the prior year, preventing nearly $1.5 billion in fraudulent refunds.

Reverse Mortgages for Seniors

By Louis E. Conrad II

- Home equity is often a senior's largest untapped asset. For those seniors who have limited resources to meet their living expenses and who own their own home, a reverse mortgage can be one solution to generating additional income.

For many seniors the value of their home is their largest asset. Depending on the amount of their living expenses and their other financial resources, some seniors may find themselves "house rich and cash poor." One technique to generate additional retirement income is to obtain a reverse mortgage, which allows you to borrow from the equity in your home. Long considered a strategy of last resort, reverse mortgages have become more popular as their costs and seniors' financial resources have declined.

The Basics

In essence, a reverse mortgage allows you to convert your home's equity into cash. To qualify for a reverse mortgage, you must be at least 62 years old and your home should be your primary residence and have little or no mortgage. Your income and credit are not verified. The maximum amount of equity that may be borrowed is $625,000, but the available borrowing is dependent on several factors, including the home's appraised value, the interest rate, and the age of the youngest borrower. The older the youngest borrower, the more that can be borrowed up to the $625,000 limit.

The borrower elects how they wish to receive their cash: as a lump sum, a monthly payment, or a line of credit. However received, the cash is considered to be tax-free income and can be used for any purpose.

Repayment of the loan occurs only after one of the following occurs: (1) you no longer occupy the home as your principal residence, (2) the last remaining owner passes away, (3) the home is sold, or (4) you permanently move out. The amount that is ultimately owed on a reverse mortgage cannot exceed the underlying home's value.

Though a reverse mortgage may be seen as a panacea, there can be drawbacks. For example, while a reverse mortgage does not affect Social Security or Medicare benefits, it can impact Medicaid and other government-sponsored aid programs. You should consult with an elder law attorney to determine the impact a reverse mortgage could have on your situation. In addition, if you have equity in excess of the borrowing limit, you will not be able to borrow that excess equity. Finally, if you expect to move from your home within a few years, the cost of securing a reverse mortgage can make such a mortgage uneconomical.

The Costs

Costs incurred for a reverse mortgage are similar to those of a standard mortgage, are often capped by federal guidelines, and most may be financed as part of the mortgage. Most reverse mortgages fall under the FHA-insured Home Equity Conversion Mortgage (HECM) program, which charges a 2% origination fee on the first $200,000 and 1% thereafter, with a $6,000 cap. A minimum insurance premium (MIP) of 2% is also charged, plus an annual premium of 0.5% of the outstanding loan balance thereafter. The MIP provides a guarantee that if your loan servicer ever goes out of business, the federal government will continue to provide access to your funds. The other costs associated with a reverse mortgage, such as an appraisal fee and closing costs, are consistent with standard mortgages.

The HECM Saver option, introduced in October 2010, has significantly reduced origination and MIP fees. Under this program, some lenders have reduced or eliminated their origination fee and the MIP is now 0.01%, though the offset is less of your home's equity may be borrowed against.

For cash-strapped seniors who wish to remain in their home and who have significant home equity, a reverse mortgage can be one solution to meeting life's expenses.

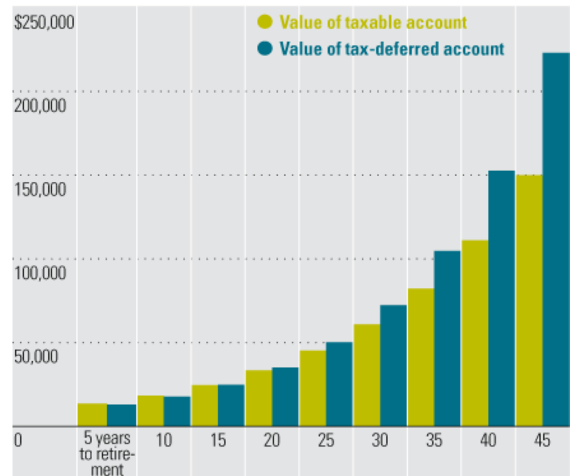
Take Advantage of Tax-Deferred Accounts

- One distinction not outlined in the article is the difference between tax-free Roth IRAs and tax-deferred Traditional IRAs.
- Contributions to a Roth IRA are made with after-tax dollars and thus are subsequently free of taxes during the owner's lifetime.
- Roth IRAs can be a wise choice for those below the income threshold (or who have converted non-Roth IRAs), especially if your income tax rate will be higher in retirement.

One of the main reasons why retirement accounts are so beneficial is the power of tax deferral. In a tax-deferred investment vehicle such as a 401(k) plan or an IRA, your earnings are not taxed until you begin withdrawing money from your account in retirement. Consider the image. A hypothetical value of $10,000 is invested in both a taxable and a tax-deferred account. The difference in value between the two accounts becomes quite substantial after 20+ years. For investors with a long investment time horizon, a tax-deferred portfolio is an excellent choice.

Please keep in mind that once you begin to withdraw money from your retirement account, you will be taxed accordingly. However, since you will most likely earn less in retirement, withdrawals from a deferred portfolio may be taxed at a lower rate.

Benefits of Deferring Taxes



Withdrawals of tax-deferred accumulations are subject to ordinary income taxes. A 10% federal tax penalty may apply to withdrawals made before age 59½. Returns and principal invested in stocks are not guaranteed.

Source: This hypothetical example is for an investor in the 28% bracket using the 2010 tax code (estimated to become the 31% tax bracket in 2013). $10,000 is invested in stocks at the beginning of year 1 (2011). Assumes an 8% annual total return (6% price return and 2% income return) and a 15% tax rate on capital gains and dividends in year 1 (2011) and year 2 (2012), after which the rates revert to 20% and the investor's marginal tax rate, respectively. The investment is taxed at a 28% marginal tax rate in year 1 (2011) and year 2 (2012), and then reverts to 31%. Taxes are assessed yearly on the taxable account but only at the end of the period on the tax-deferred account. Estimates are not guaranteed.

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