Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

Kane Company, P.C. 515-270-2727 Spring 2014

You Have Entered The Twilight Zone—Of Taxation

Rod 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 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 by surprise.

4. Net investment income tax. The "net investment income" (NII)

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2014 Updates

Please be aware of these 2014 tax-related updates:

- Standard Mileage Rates. Business: 56 cents per mile; Charitable: 14 cents per mile; and Medical/ Moving: 23.5 cents per mile.
- The maximum IRA contribution amount remains the same in 2014 at $5,500 ($6,500 if at least age 50). Maximum 401(k) contributions have also remained $17,500 ($23,000 if age 50). The option to convert to a Roth IRA is still available regardless of income, but all conversion taxes must be paid in year of conversion.
- The maximum Simple IRA elective deferral amount is $12,000 in 2014. For participants who are age 50 or over at the end of the calendar year can also make catch-up contributions of no more than $2,500 ($14,500 total).
- The maximum Iowa tax deductible contribution to College Savings Iowa for 2014 is $3,098 per person (participant) per child beneficiary.

The 2014 update of our Registered Investment Advisor Disclosure Brochure is now available, which highlights the qualifications and business practices of our fee-only investment advisory services. Please contact us for a copy.

Please note: our business hours are 8:00am to 4:00pm Monday-Thursday and 8:00am to 3:00pm on Fridays now through December.

Steven L. Kane, CPA/PFS, CFP®

Count On The Portability Provision

Though 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 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 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. ●

Markets May Not Be Certain, But Experience Is

Have you ever wished you could do it all over again? Experience can be a great teacher, and it's natural to imagine that with the benefit of hindsight you would have made better decisions about everything from raising your children to managing your financial affairs. And while that may or may not be true, what is certain is that you can offer younger family members some of the insight you've acquired along the way.

Here are some thoughts you might pass along:

1. When you get a pay raise or a new higher-paying job, consider earmarking at least part of the additional money for retirement savings. You'll be amazed by what tax-deferred compounding can do to even relatively small sums over the course of several decades. And using raises to increase your contribution to a 401(k) can be relatively painless. Ratchet up your saving rate by a percentage point or two each year and you'll soon reach the maximum for annual pre-tax contributions to 401(k)s and similar employer-sponsored plans—$17,500 in 2014 if you're younger than age 50. Beginning at 50, you'll be eligible to contribute an extra $5,500 a year.

2. Try to resist the siren song of early retirement. Leaving your job in your 50s may be tempting, but it runs counter to several financial realities. Most people have not saved enough to retire comfortably even at the traditional age of 65, and quitting early can mortgage your future in two ways—reducing the amount you can save while extending the time that your savings must support you. By the same token, however, every year you keep working improves your situation. Moreover, as life expectancies increase, more and more people find they want to stay on the job at least part-time, and not only for financial reasons. Working can help keep you engaged and healthy,

Figure Your Investment Risk And Cope With It

Are 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 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. ●

particularly if you find something you really like to do.

3. Consider postponing Social Security. You can begin receiving benefits as early as age 62, but each year you delay will increase the amount of your monthly payment, and if you wait until age 70, you'll get 76% more than if you had started drawing benefits at 62. And most people will live long enough to get a larger total payout if they begin later.

4. Don't feel like you have to go it alone in making financial decisions. Working with an advisor could help you make sense of complex financial markets and chart a comfortable path toward your goals. The right advisor can assist you in deciding how much to save, how to allocate your investments, how to weigh the pros and cons of buying a home and other major financial choices, and, when the time comes, how to deploy your retirement nest egg. ●

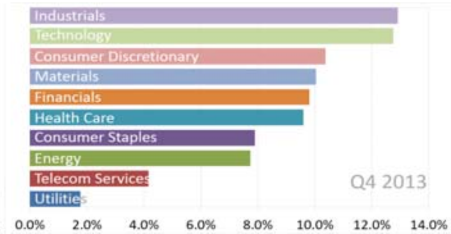
Market Data Bank: 4th Quarter 2013ᵠ

U.S. STOCKS

4Q2014's hefty profit was especially surprising following the market's sharp run-up during the previous nine months. For 2013, the S&P 500 price index appreciated an astounding 29.6%!

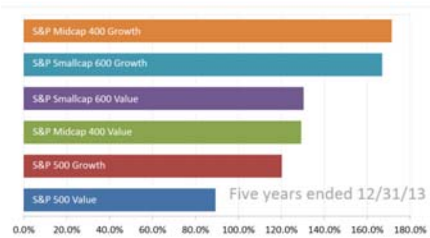
FOREIGN VS. U.S. STOCKS

The U.S. led the global economy out of recession, and that's reflected in the stunning outperformance of U.S. versus foreign stocks. Emerging market stocks, with far more risk, ran a distant second.



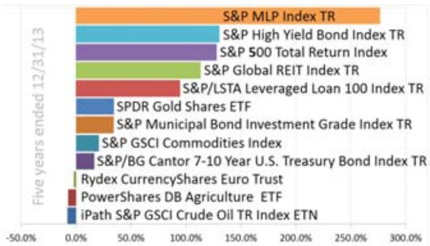
LARGE-CAP U.S. STOCKS BY INDUSTRY

The 10 S&P 500 industry sectors showed a wide dispersion in Q4 2013 returns—about a 10 percentage point spread between the winning and losing sectors. This indicates why it is so important to enforce a rebalance discipline.



U.S. STOCKS BY MARKET CAP AND STYLE

With the market breaking all-time highs in recent months, talking heads on financial TV are likely to sound more fearful or become greedier. Tune it out and stay focused on making long-term strategic decisions.



ASSET CLASSES±

Master Limited Partnerships, a relatively new asset class, outpaced everything else by a wide margin. Economy-sensitive high-yield bonds and stocks were also five-year leaders. U.S. Treasury bonds plunged in the rankings as global-crisis-inspired fear subsided.

S&P 500 INDEX VS. EARNINGS¥

The forecast of Wall Street analysts for earnings on the S&P 500 index, as of 12/26/2013, was for $121 per share in 2014 and $134 in 2015. At the recent valuation levels, that could propel stock prices to follow the trajectory shown in the markers in red in 2014 and 2015

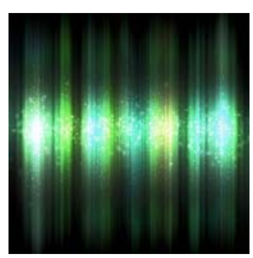
Past performance does not indicate future results. ±Indices and ETFs representing asset classes are unmanaged and not recommendations for any specific investment. Foreign investing involves special risks, including political or economic instability and currency fluctuation. Bonds offer a fixed rate of return while stocks fluctuate. ¥Estimated bottom-up S&P 500 earnings per share as of December 26, 2013 was $109.13 for 2013, $120.88 for 2014 and $133.91 for 2015. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through December 31, 2013; and actual earnings data through September 30, 2013.

Twilight Zone Of Taxation

(Continued from page 1)

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. ●

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