# Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

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# New 3.8% Medicare Surtax Spurs Year-End Action

No one ever said year-end tax planning in 2012 would be easy. For starters, the elimination of the "Bush tax cuts" will result in higher federal tax rates for income, capital gains, and dividends, beginning in 2013 (unless Congress enacts new legislation). But there's another major tax change in store for next year: a new 3.8% surtax that will hit some high-income investors.


The 3.8% Medicare surtax applies to the lesser of your "net investment income" or the amount by which your modified adjusted gross income (MAGI) exceeds either $200,000 for single tax filers or $250,000 for joint filers. Net investment income includes interest, dividends, royalties, rents, gains from sales of property (other than property held in an active trade or business), and income from passive activities, but not tax-exempt interest or distributions from IRAs and qualified retirement plans.

Facing this prospect, high-income investors may want to take steps before the end of this year to reduce the sting of the surtax next year. Here are several ideas to consider:

• **Sell assets soon or hold on.** If the law doesn't change before 2013, you might decide to sell stocks, rental real estate, or other assets in 2012. That will help you avoid both the higher tax rates on capital gains and the 3.8% surtax that will kick in next year. Of course, any asset sale also needs to make sense from a financial perspective. If you decide to hold on to most of your investments for now you could still sell them later during a year in which your income is relatively low (and you'll be in a lower tax bracket).

• **Sell property on an installment sale basis.** If you've decided to sell property such as rental real estate and you have a good offer in hand, you might arrange an installment sale. As the name implies, the buyer will make regular payments over two or more years. (Most buyers will agree to this gladly.) By paying capital gains tax only on the portion of the payment received in a particular year, you'll spread out the tax liability and you may be able to stay below the threshold for triggering the 3.8% surtax. Alternatively, you can elect to be taxed on the entire gain in the year of the sale.

• **"Hide" income in IRS-approved tax shelters.** It's a myth that there are no more tax shelters. For instance, if you invest in life insurance or annuities, you don't owe any current tax on the funds building up in your account. Life insurance proceeds aren't paid until the insured person dies, while a deferred annuity may let you "leapfrog" your high-income years and receive taxable distributions when you're earning less. Also, income from municipal bonds is completely free of federal income tax. Other investment opportunities, such as rental real estate and oil gas and deals, may provide tax

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## *Analyzing Possible 2013 Tax Scenarios*

With the fiscal landscape uncertain, it is more important than ever to plan for possible 2013 tax scenarios. If Congress does not extend the present tax rates and the expiration of the "Bush tax cuts" occurs, it will impact basically all U.S. taxpayers in the form of higher tax rates, smaller tax brackets, lower personal exemption and standard deduction amounts, reduced and expiring credits, and slower depreciation deductions. Couple those possible changes with the upcoming Medicare surtaxes, and 2013 could look very different for many taxpayers. We have attended income tax workshops discussing potential 2013 tax scenarios, so please contact us if you would like us to estimate your situation.

Year-End Reminders! December 31 is the deadline for Roth IRA conversions and College Savings Iowa contributions. We can assist in pension and IRA rollovers, or any required minimum distributions (RMDs) you may need to complete before year-end.

We will be closed for the holidays starting at noon on Dec. 24th through Dec. 25th. Also, our office hours will be extended in January through April 15th to accommodate our tax clients. Extended hours: Monday through Friday from 8am-5pm and Saturdays from 8:30am-12pm.

Thank you very much for your continued patronage and referrals. We wish all of you a happy and healthy holiday season, as well as a prosperous New Year!

*Steven L. Kane, CPA/PFS, CFP®*

# Avoid These 7 Investment Mistakes

One thing that can be puzzling about stock market investors who have struggled in the past: They make some of the same mistakes over and over. Here are seven prime examples.

**1. You try to "time" the stock market.** Typically, timing strategies are based on selling stocks when you believe the market has topped out and buying when you think it has hit rock bottom. The problem is that nobody—and we mean NOBODY—has a crystal ball that's foolproof. It's far better to stick with a well-diversified, balanced portfolio based on your personal circumstances.


**2. You have zero patience.** If you're looking for instant gratification, the stock market will disappoint you more often than not. Just as for the tortoise and the hare, slow and steady usually wins the race, while those who act too swiftly finish behind. Be content to hold some stocks for a long time before you reap rewards.

**3. You refuse to recognize reality.** All too often, investors operate with blinders on, but the cold hard facts can't be ignored. If you have a favorite stock you were convinced would turn a profit and it simply hasn't worked out, don't throw good money after bad. Dump the losers and hold on to the winners without allowing emotion to rule the day.

**4. You put all of your eggs into one basket.** No matter what the projections are for any particular stock, sector or asset type, it's not smart to bet your entire wealth on its performance. Diversification is a key element of a sensible plan for virtually every investor. It's all about balancing the search for reward with the need to reduce risk. Although there's less chance you'll make a killing if you diversify, you reduce your exposure to a catastrophe.

**5. You overemphasize past performance.** It may be boilerplate language in investment prospectuses and related materials, but it's also true: "Past performance is not necessarily indicative of future results." Don't build your portfolio around particular stocks just because they've been profitable without evaluating their current and future prospects.

**6. You ignore the impact of taxes.** It only makes sense to consider the tax ramifications of your investment decisions—especially now, with investment and income tax rates set to rise in 2013 and the arrival of a new 3.8% Medicare surtax for high-income investors. But it also can be a mistake to let taxes drive your decisions. Weigh all of the relevant economic factors when you buy or sell stocks.

**7. You don't have a plan.** Many investors take a hit-or-miss approach to their portfolio. They buy and sell on whims without coordinating their activities. But you're more likely to be successful if you develop an overall plan that is suitable for your situation. Having a strategy and having the discipline to stick with it is the hallmark of successful investing. We would be glad to provide whatever assistance you need. ●

# Which Funds To Tap In Retirement?

Unless you're independently wealthy, eventually you'll have to start using some of the money you've saved for retirement. After all, that's what it's there for, so there's nothing wrong with using those assets. But it could create problems if you spend the "wrong" funds first.

For purposes of deciding what to spend when, let's divide your retirement assets into three baskets: personal accounts, such as stock and bond holdings that are currently taxable; traditional IRAs and qualified retirement plans, such as a 401(k), income from which is typically taxed only when withdrawn during retirement; and non-taxable accounts, such as Roth IRAs.

The rule of thumb is to withdraw funds from your personal accounts first, your traditional IRAs and qualified plans second, and your Roth IRAs third. This spending order is likely to produce the lowest possible tax bill, promote more tax-deferred growth, and allow you to milk your assets for as long as possible. If you were to spend your money in the reverse order, you would pay more in taxes each year, thereby siphoning off funds that could have been reinvested and reducing your overall nest egg—and maybe even exhausting all your funds during your lifetime.

The preferred "spending order" in retirement is only reinforced by tax law changes scheduled to take effect in 2013. Barring last-ditch legislation, the tax brackets for individuals will be adjusted upward, with the current top tax rate of 35% being replaced by 39.6%. Furthermore, the maximum capital gains rate of 15% for most investors (0% for low-income investors) is increasing to 20% (10% for low-income investors). And qualified dividends, currently taxed at a rate no higher than 15%, will be taxable at ordinary income rates.

To add insult to injury for high-

# Stock Valuations By Historical Standards

The stock market is fickle and unpredictable, but it's not overvalued.

In fact, if the companies in the Standard & Poor's 500 Index deliver 2012 earnings at or near the consensus level expected by Wall Street analysts, stocks would be poised for gains. In addition, if earnings falter, stock prices may drop, but the low valuation level as measured by historical standards, would seem to be working in favor of investors.

**What's A Stock Worth?** Earnings are the ultimate determinant of stock prices, and the price/earnings (p/e) ratio on stocks is the key metric. The p/e ratio on U.S. companies in the Standard & Poor's 500 Index in mid-September, after a strong summer rally, was 14; investors were willing to pay $14 for every dollar earned by U.S. companies in the S&P 500 over the previous 12 months. The S&P 500 is a broad barometer of the value of large U.S. companies,

**Historical Comparison.** At 14, the p/e ratio was less than half its level at the top of the technology stock bubble of 2000. In that speculative period, according to analysis by Fritz Meyer Economic Research, an independent consultant to institutional investors, the S&P 500 traded at a p/e multiple as high as 30 — and the usually-tight correlation between stock prices and earnings broke down. The accompanying graphic shows a significant gap opening up and separating the price of S&P 500 stocks from the underlying earnings.

**Global Slowdown.** Stocks, during the first eight-and-a-half months of 2012, turned in an impressive 16% total return, but a slowdown of economic growth globally could end the rally. As companies were poised to report third-quarter earnings, fears of disappointing profits grew. A global economic slowdown could quickly cause a big drop in stock prices. What's the chance of that? While you can't expect past performance to repeat itself, using history as a guide is helpful when trying to see into the future. So let's look at the last few market pullbacks.

**Standard & Poor's 500 Index: Share Prices Versus Earnings**


* Estimated 2012 and 2013 bottom-up S&P 500 earnings per share (left axis), as of August 31, 2012, for 2012 is $103.32 and for 2013 is $115.40.

Sources: Yardeni Research, Inc. and Thomson Financial survey of consensus estimates; Standard & Poor's for index price data through September 6, 2012; and actual earnings data through June 30, 2012.

**Nothing Goes Straight Up.** From its Global-Financial-Crisis low of 683 in early March 2009, the S&P 500 Index climbed to 1464 in mid-September 2012 — more than doubling in value over 30 months. But stock prices did not go straight up in this period. After hitting 1217, in April 2010, the index plunged 16% over 10 weeks to 1022, only to recover over the next year to 1363, before pausing to drop 10% early this summer and then shooting to the 1460s. Keep in mind, the strong ascendance in stock prices still has not surpassed the October 2007 pre-Crisis all-time high on the S&P 500 of 1561.

**Inflation Supportive.** The amount that investors are willing to pay for a dollar of corporate profits —stock valuations — depends on a range of factors, and one key factor is inflation. According to Meyer, in periods of unusually high inflation, such as in 1980 when the inflation rate soared to a 14% annual rate, the p/e ratio on stocks shrunk and stocks were valued at just eight times their trailing 12-month earnings. However, in times of moderate inflation, investors historically have valued stocks at between 15 and 20 times earnings. "Considering that inflation is currently running at a low rate of 2% annually," says Meyer, "a p/e multiple of 14 was below the historical range and that's very encouraging."

**Analyst Revisionism.** According to Meyer, it's not uncommon for analysts to ratchet down earnings toward the end of the year. "It's a very typical pattern for Wall Street analysts to start out the year overly exuberant and then shave their earnings estimates toward the end of the year," says Meyer. "What's significant is that 2012 and 2013 earnings estimates by Wall Street analysts have been holding up remarkably well."

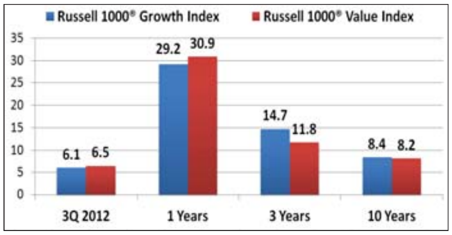
**Multiple Expansion.** While the potential risks of investing in stocks are real, so, too, are the possible rewards. Earlier this year, the consensus earnings forecast of Wall Street analysts called for the companies in the S&P 500 Index to earn $103.32 per share for 2012. "If 2012 earnings are indeed delivered at a level close to where they were forecast to come in at," Meyer says, "then stock valuations would be very reasonable, and multiple expansion could boost stock prices." ●

income investors, a new 3.8% Medicare surtax debuts in 2013. Under a special tax law provision, an investor must pay the 3.8% surtax on the lesser of "net investment income" or the amount by which modified adjusted gross income (MAGI) exceeds a threshold of $200,000 for single filers or $250,000 for joint filers. "Net investment income" includes most forms of taxable income, such as capital gains and dividends, but not distributions from qualified retirement plans and IRAs or tax-exempt income. Still, those items may increase your MAGI for this calculation.

Despite these tax-based incentives, remember that you generally have to begin taking "required minimum distributions" (RMDs) from qualified retirement plans and IRAs—but not from Roth IRAs—after age 70½. If you've reached that point, you may as well take the RMD amounts first before the regular sequence.

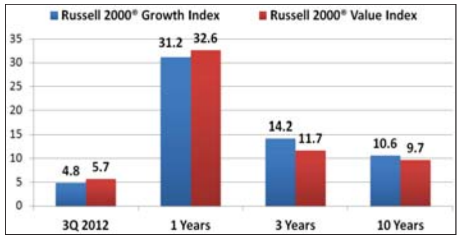
Last but not least: Everyone is different, so you may have valid reasons for changing the usual order. If you have any questions about your situation, please let us know. ●

# Market Data Bank: 3rd Quarter 2012



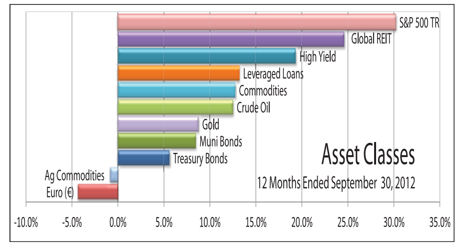

### LARGE VALUE VS. LARGE GROWTH

In 3Q12, stocks continued a rebound that began after the world financial crisis. A 14.7% average annual return on large-growth over three years is well above the historical long-term norm.




### SMALL VALUE VS. SMALL GROWTH

Small-cap growth has outdone small value over longer periods. Small-caps underperformed large-caps in 3Q12 but small companies have delivered better annualized returns than large-caps over 10 years.




### ASSET CLASSES

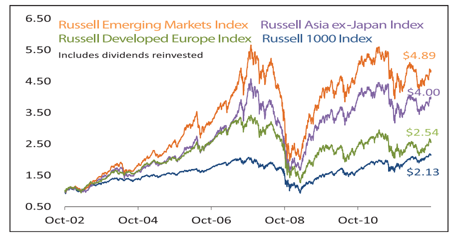
The Standard & Poor's 500 stock index was the best of a broad range of asset classes in the 12 months ended 9/30/12. After being battered in the financial crisis, the stock comeback shows how broad diversification can work over the long haul.


### US STOCKS & US BONDS

Slow growth since the 2007 global financial crisis has led the Federal Reserve to keep interest rates low to provide liquidity to the economy. Low yields on bonds made stocks attractive, and stock prices have climbed


### S&P 500 VS. EARNINGS

Estimated 2012 and 2013 S&P 500 earnings per share on 9/27/12 was $103.37 for 2012 and $115.19 for 2013. If companies meet estimates, the S&P 500 could be propelled to reach toward the red squares.




### FOREIGN STOCK MARKETS

$1 invested in U.S. large-company stocks grew to $2.13 for the 10 years ended 9/30/12, while it grew to $4.89 in emerging markets stocks, $4 in Asian stocks (excluding Japanese equities), and $2.54 in European stocks.

**Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital/International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do nott represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.**

*Source: Russell/Mellon*

## Surtax Spurs Year-End Action

*(Continued from page 1)*

breaks that reduce net investment income for purposes of the 3.8% surtax.

• **Convert to a Roth IRA.** The usual payoff for converting funds in a traditional IRA to a Roth is that future distributions can be 100% tax-free. But you have to pay current tax on the value of the assets you move into the new account. By converting before the 3.8% surtax hits in 2013, you can reduce the overall tax bite. Or you could decide to make the conversion over several years to minimize the effect on your income (and your tax rate).

• **Establish a charitable remainder trust (CRT).** A CRT lets you transfer assets to a trust that eventually will benefit a designated charity—and that will, in the meantime, provide income to a beneficiary you designate. The beneficiary receives income from the assets over the trust term, thereby spreading out the tax liability and reducing the likelihood that the beneficiary will be subject to the surtax. When the term expires, the remainder goes to the charity. Just keep in mind that this is a complex arrangement that needs to be considered as part of your overall estate plan.

• **Put family members on the payroll.** Remember that "net investment income" includes income from sales of passive investments—but not from property that's part of an active trade or business. By hiring younger family members to work for your firm, you can significantly reduce their "net investment income" for the surtax calculation. The savings can be enormous for those involved with highly valued businesses. Of course, the family members must perform bona fide duties.

These are just several ideas for minimizing the impact of the 3.8% Medicare surtax. We can work with your tax advisor and your attorney to help you plan steps that make sense in your situation. ●

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