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As we enter the last few weeks of 2012, we wanted to take this opportunity to share some timely year end articles with you.

We'd also like to wish you all a happy and healthy holiday season and best wishes for the New Year!

Best regards,

Kevin Graham

December 2012 & The Fiscal Cliff

On the Precipice: the "Fiscal Cliff"

The phrase "fiscal cliff" has been used to describe the unique combination of financial realities scheduled to take effect in 2013: expiring tax breaks; the imposition of new taxes on high-income individuals; and automatic deficit-reduction spending cuts.

Expiring tax breaks

Lower federal income tax rates, part of the tax landscape for more than ten years, expire at the end of 2012. We'll go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%). The maximum rate that applies to long-term capital gains will generally increase from 15% to 20%. And while the current lower long-term capital gain rates now apply to qualifying dividends, starting in 2013, dividends will be taxed as ordinary income. The temporary 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax, in place for the last two years, also expires at the end of 2012, as do temporary breaks relating to the federal estate and gift tax.

Several other significant breaks go away in 2013 as well. Itemized deductions and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs); the earned income tax credit, the child tax credit, and the American Opportunity (Hope) tax credit all revert to old, lower limits and less generous rules; and individuals will no longer be able to deduct student loan interest after the first 60 months of repayment. Lower alternative minimum tax (AMT) exemption amounts (the AMT-related provisions actually expired at the end of 2011) mean that there will be a dramatic increase in the number of individuals subject to AMT when they file their 2012 federal income tax returns in 2013.

New taxes

Beginning in 2013, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for individuals with wages exceeding $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals. This 3.8% contribution tax applies to some or all of the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Mandatory spending cuts

The failure of the deficit reduction supercommittee to reach agreement in November 2011 automatically triggered $1.2 trillion in broad-based spending cuts over a multiyear period beginning in 2013 (the official term for this is "automatic sequestration"). The automatic cuts are to be split evenly between defense spending and non-defense spending. Although Social Security, Medicaid, and Medicare benefits are exempt, and cuts to Medicare provider payments cannot be more than 2%, most discretionary programs including education, transportation, and energy programs will be subject to the automatic cuts.

Understanding the "cliff"

Many fear that the combination of tax increases and spending cuts will have severe negative economic consequences. According to a report issued by the nonpartisan Congressional Budget Office *(Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013, May 2012),* taken as a whole, the tax increases and spending reductions will reduce the federal budget deficit by 5.1% of gross domestic product (GDP) between calendar years 2012 and 2013. The Congressional Budget Office projects that under these fiscal conditions, the economy would contract during the first half of 2013 (i.e., we would likely experience a recession).

How to Give Wisely and Well

These are a few of the organizations and agencies that publish reports and charity ratings, and/or give useful tips and information to consumers on choosing a charity and giving wisely:

- ***Better Business Bureau's BBB Wise Giving Alliance, www.bbb.org***
- ***Charity Navigator, www.charitynavigator.org***
- ***CharityWatch, www.charitywatch.org***
- ***Federal Trade Commission, www.ftc.gov***

Giving to charity has never been easier. You can donate the old-fashioned way--by mail--but you can also donate online, by text, or through social networking sites. According to the National Center for Charitable Statistics, over 1.4 million nonprofit organizations are registered with the IRS. With so many charities to choose from, it's more important than ever to ensure that your donation is well spent. Here are some tips that can help you become both a generous and wise donor.

Choose your charities

Choosing worthy organizations that support the causes you care about can be tricky, but it doesn't have to be time-consuming. There are several well-known organizations that rate and review charities, and provide useful tips and information that can help you make wise choices when giving to charity (see sidebar). To get you started, here are some questions to ask:

- *How will your gift be used?* It should be easy to get information about the charity's mission, accomplishments, financial status, and future growth by contacting the charity by phone or viewing online information.
- *How much does the charity spend on administrative costs?* Charities with higher-than-average administrative costs may be spending less on programs and services than they should, or may even be in serious financial trouble. Some charities who use for-profit telemarketers get very little of the money they raise, so ask how much of your donation the charity will receive.
- *Is the charity legitimate?* Ask for identification when approached by a solicitor, and never give out your Social Security number, credit card number, bank account number, account password, or personal information over the phone or in response to an e-mail you didn't initiate. There's no rush--take time to check out the charity before you donate.
- *How much can you afford to give?* Stick to your giving goals, and learn to say no. Legitimate fundraisers will not try to make you feel guilty, and will be happy to send you information that can help you make an informed decision rather than pressure you to give now.

Harness the power of matching gifts

Many employers offer matching gift programs that will match charitable gifts made by their employees. You'll need to meet certain guidelines--for example, your employer may only match your gift up to a certain dollar limit--and the charity may need to provide information. Check with your employer's human resources department or the charity to find out how you can maximize your donations through a matching gift program.

Put your gifts on autopilot

If you're looking for an easy way to donate regularly to a favorite charity, look into setting up automatic donations from a financial account. When donors contribute automatically, the charity benefits by potentially lowering fundraising costs and by establishing a foundation of regular donors. And you'll benefit too, because spreading out your donations throughout the year may enable you to give more, and will simplify your record keeping.

Look for new ways to give

Although cash donations are always welcome, charities also encourage other types of gifts. For example, if you meet certain requirements, you may be able to give stock, direct gifts from your IRA or other retirement account, real estate, or personal property (but check with your financial professional to assess potential income and estate tax consequences based on your individual circumstances). You can also volunteer your time, using your talents to improve the lives of others in your community. And taking a "volunteer vacation" can be a fun way to involve your family and meet other people across the country or world who share your enthusiasm for a particular cause.

Use planned giving to leave a legacy

You can leave an enduring gift through your estate. For example, you might leave a will bequest, give life insurance, or use a charitable gift annuity, charitable remainder annuity trust, or charitable unitrust that may help you give away the asset now, while retaining a lifetime interest--check with your financial or tax professional regarding any potential estate or tax benefits or consequences.

Keep good records

If you itemize when you file your taxes, you can deduct donations you've made to a tax-qualified charity, but you may need documentation. Keep copies of cancelled checks, bank statements, credit card statements, or receipts from the charity showing the charity's name and the date and amount of the contribution. For donations or contributions of $250 or more, you'll need a more detailed written acknowledgment from the charity. For more information and a list of requirements, see IRS Publication 526, Charitable Contributions.

Life Insurance Tax Traps for the Unwary

If you take a loan against your cash value, the death benefit available to your survivors will be reduced by the amount of the loan. In addition, policy loans may reduce available cash value and can cause your policy to lapse. Finally, you could face tax consequences if you surrender the policy with an outstanding loan against it.

Life insurance has been recognized as a useful way to provide for your heirs and loved ones when you die. Lawmakers have long recognized the social significance of life insurance as a source of funds for widowed spouses and children, and have offered liberal tax benefits as an incentive to those who put their hard-earned dollars into life insurance policies. However, there are a number of situations that can easily lead to unintended and adverse tax consequences. Here are some of the life insurance tax traps you may want to avoid.

Policy loans

One area fraught with unintended tax ramifications involves life insurance policy loans. A number of different scenarios involving policy loans can result in unplanned taxes, but one of the most common situations arises when a policy is surrendered (cancelled) or lapses with an outstanding policy loan.

Generally, if a policy is surrendered or lapses while a loan is still outstanding, the loan balance becomes taxable to the policyowner as ordinary income to the extent the cash value exceeds the owner's basis (net premiums paid less any tax-free distributions received) in the policy--it's as if cash from the policy is distributed to pay off the loan.

Example: *You own a life insurance policy into which you paid premiums of $100,000 (your basis); the policy cash value is $200,000; and there is an outstanding policy loan of $150,000. You surrender the policy for $50,000 cash (the difference between your cash value and loan balance). However, much to your surprise, you'll have to include $100,000 as ordinary income for the tax year in which you surrender the policy ($150,000 loan balance + $50,000 cash - $100,000 premiums).*

Modified endowment contract (MEC)

Since 1988, if the total premiums paid during the first seven years of the policy exceed a maximum amount based on the death benefit, then the policy becomes a MEC. The tax-free treatment of the death benefit and the tax-deferred cash accumulation are generally the same for MEC and non-MEC life insurance, although the tax consequences for pre-death withdrawals are different.

For non-MEC policies, partial and full surrenders are taxed on a first-in, first-out basis, meaning cash value withdrawals are considered first coming from your investment in the policy (i.e., your premiums) then from any gain in the cash value (i.e., interest/earnings). Generally, policy loans from non-MECs are not subject to income tax.

But any withdrawals (including loans and partial or full surrenders) taken from the cash value of a MEC are treated as coming from earnings first and are taxed as ordinary income to the extent the policy's cash value exceeds your basis. In addition, if the policyowner is under age 59½, a 10% tax penalty may be assessed on the amount withdrawn from a MEC that's includible as income unless an exception applies.

Example: *You purchased a cash value life insurance policy with a single premium of $100,000, making the policy a MEC. The policy cash value has grown to $150,000. If you take out a loan of $75,000 against the cash value, you will have to include $50,000 of the loan amount as ordinary income ($50,000 of the total amount borrowed represents gain in the policy).*

Estate planning

Generally, the life insurance death benefit is includible in the estate of the policyowner and may be subject to federal and/or state estate tax. Often, attempts to remove the policy from the owner's estate create problems. A quick solution has the owner transferring ownership of the policy to another person or an irrevocable life insurance trust (ILIT), in an attempt to remove the policy from the estate. However, if an insured owns a policy on his or her own life and gives the policy to another person, trust, or entity and then dies within three years of the transfer, the death benefit will be included in the estate of the insured/transferor, subject to possible estate tax.

Issues may arise when the policyowner, insured, and beneficiary are three different parties. If the insured is the first to die, the policy proceeds are considered a gift from the owner to the beneficiary, subject to potential gift tax. Generally, the owner and insured should be the same, or the owner and beneficiary should be the same party.

Unintended ownership issues may result if the insurance policyowner and insured are different parties, and the owner is the first to die. If the policy owner did not name a successor owner, then the policy will be subject to probate, including possible creditors' claims and unnecessary costs. To avoid this scenario, the owner should name a successor owner.

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What health-care provisions are effective in 2013?

With the Supreme Court's favorable ruling on the constitutionality of the Patient Protection and Affordable Care Act (ACA), more of the law's provisions will become effective in 2013. Here are some of the new features that may be important to you.

Medicare Part D participants who reach a gap in their drug coverage (the "donut hole") are required to pay the entire cost of prescription drugs out-of-pocket. In 2013, the ACA will continue to close this gap by increasing subsidies to reduce the cost of brand-name and generic drugs to participants who reach the donut hole. These subsidies will continue until 2020, when the participant's maximum contribution toward the cost of prescriptions will be reduced to 25%.

The threshold for the itemized deduction for medical expenses increases from 7.5% to 10% of adjusted gross income, beginning in 2013. However, this increase is waived for taxpayers age 65 and older through 2016.

In 2013, the annual pretax employee contribution to a Section 125 cafeteria plan flexible spending account (FSA) is reduced to $2,500, subject to annual increases for cost-of-living adjustments. The reduction does not apply to certain employer nonelective contributions (e.g., flex credits).

Beginning in 2013, the hospital insurance (HI) portion of the payroll tax, commonly referred to as the Medicare portion, increases by 0.9% for individuals with wages exceeding $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

In addition, 2013 marks the imposition of a new 3.8% Medicare contribution tax on the unearned income of high-income individuals. This 3.8% contribution tax generally applies to the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Looking ahead, 2014 brings the implementation of the health insurance exchanges, premium and cost-sharing subsidies, and the requirement that most individuals have health insurance.

How does health-care reform affect women?

The Patient Protection and Affordable Care Act (ACA) expands women's access to health insurance and adds several reforms to the existing health-care system that are specifically beneficial to women.

Access to care and affordability are important issues for women. According to the U.S. Department of Health and Human Services, because almost twice as many women than men who receive employer-provided health insurance are covered as dependents, they are susceptible to losing that coverage should they become widowed, divorced, or if their husbands lose their jobs.

In addition, the cost of coverage may significantly impact women. Women earn less than men, on average, and are more likely to be out of the workforce to care for children, parents, or other dependents. Because of this trend, out-of-pocket costs such as co-pays, deductibles, and premiums can pose a particular threat to women's access to affordable care.

The ACA provides for the creation of state-level health insurance exchanges, available to small businesses and uninsured individuals, that will serve as a marketplace of private and public health plans. Individuals and families purchasing insurance through insurance exchanges may be eligible for subsidies or tax credits (based on income) that can be applied towards the cost of insurance. According to the U.S. Census Bureau, 20% of women between the ages of 18 and 64, or about 19 million women, are uninsured. Of those, it is estimated that 36% will be eligible for tax credits and subsidies.

ACA specifies essential health benefits for women that must be offered by nongrandfathered plans. These benefits include maternity and newborn care, including prenatal visits and pediatric services. Several preventive services must be offered without co-payments or deductibles, including mammography exams; Pap tests; colonoscopies; type 2 diabetes screening; obesity screening; several immunizations including hepatitis, influenza, and HPV; and alcohol and tobacco counseling. Specific coverage benefits will continue to be shaped by U.S. Health and Human Services regulations.

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