Korbitz Financial Planning

Newsletter

Korbitz Financial Planning LLC
Eric S. Korbitz, CPA, CFP®
PO Box 170049
Milwaukee, WI 53217
414-979-1040
eric@korbitzfinancialplanning.com
www.korbitzfinancialplanning.com

The drought we have had this year, particularly this summer, has resulted in fires, failed crops, and brown lawns. Hopefully this will be, like many things in life, a cyclical issue and we will return to normal soon. Fortunately the stock market has not suffered a similar drought. We hope the rain will fall, but the stock market will see sunny days ahead.

Please enjoy the newsletter articles and let me know if you have any questions.

Eric

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Speculating on the Future of the Federal Estate Tax

What's the future of the federal estate tax? All we know is that no one knows for sure; it's all speculation. So, let's take a look at what could happen. There are five possibilities: (1) Congress could extend current tax law (commonly referred to as the "Bush tax cuts"); (2) Congress could do nothing, essentially turning the calendar back to 2001; (3) Congress could compromise, agreeing on something between the 2001 tax rules and the rules that apply in 2012; (4) Congress could enact new estate tax reform; or (5) Congress could repeal the estate tax altogether.

Note: *Only a few of the estate tax laws that are affected are discussed here.*

Congress could extend current tax law again, probably for two years

That would mean the top gift and estate tax rate would remain at 35%. The generation-skipping transfer (GST) tax (this is an additional tax that's imposed on transfers to beneficiaries who are two or more generations below you) would also remain at a 35% tax rate. The gift and estate tax exemption (may also be referred to as an exclusion) would remain at $5,120,000 (plus any adjustment due to inflation) plus any deceased spousal unused exclusion amount (DSUEA).

The DSUEA is the amount of the gift and estate tax exemption that the first spouse to die does not use. This amount can be transferred from the estate of the first spouse to die to the surviving spouse. This is referred to as portability. Portability would remain.

The GST tax exemption of $5,120,000 plus any adjustment due to inflation would remain. There is no DSUEA for the GST tax (i.e., the GST tax exemption is not portable between spouses).

The smart money is on this possibility. It has been Congress's tendency of late.

Congress could do nothing

Congress could allow all or some of the provisions that sunset to expire, reverting to the 2001 tax rules. The top gift and estate tax rate would be 55% with a 5% surtax on estates that exceed $10 million but do not exceed $17,184,000. The GST tax rate would also be 55%. The gift and estate tax exemption would be $1 million. And, the DSUEA would no longer apply. The GST tax exemption would be $1 million indexed for inflation (estimated so far to be $1,360,000).

Some analysts have proposed letting the Bush tax cuts expire as part of a plan to balance the budget over time.

Congress could compromise

Congress could pass a compromise bill that would set the top tax rate to 45% and the exemption amount to $3.5 million. Whether portability would expire or be extended is anyone's guess.

President Obama supports this option. His 2013 budget plan would return the gift and estate tax, and the GST tax, to 2009 levels; the top tax rate would be 45%, the exemptions would be $3.5 million (but only $1 million for gift tax purposes), and portability would be made permanent.

Congress could enact estate tax reform

Many believe that permanent and comprehensive estate tax reform is needed. However, the political landscape is probably not currently amenable to this option. Besides, permanent tax reform does not really mean that it will be permanent (it could, of course, be modified or repealed by future legislation).

Congress could repeal the estate tax altogether

The arguments for and against the repeal of the estate tax continue to wash in, like ocean waves. The tide was high for repeal a few years back, but the current economic and fiscal situation may have slowed its momentum, and the tide seems to be ebbing.

Of Taxes Past, Present, and Future

Qualified charitable distributions

A popular provision allowing individuals age 70½ or older to make qualified charitable distributions of up to $100,000 from an IRA directly to a qualified charity expired at the end of 2011. These charitable distributions were excluded from income, and counted towards satisfying any required minimum distributions that you would have had to take from your IRA for the year.

Return of the "marriage penalty"?

Tax changes that were originally made to address a perceived "marriage penalty" expire at the end of 2012. If you're married and file a joint return with your spouse, you'll see the effect in the form of a reduced 2013 standard deduction amount, as well as in lower 2013 tax bracket thresholds in the tax rate tables (i.e., couples move into higher rate brackets at lower levels of income).

With the 2011 tax filing season behind us, much attention is being paid to the expiring "Bush tax cuts"--the reduced federal income tax rates, and benefits, that will expire at the end of 2012 unless additional legislation is passed. In fact, though, several important federal income tax provisions already expired at the end of 2011. Here's a quick rundown of where things stand today.

What's already expired?

A series of temporary legislative "patches" over the last several years has prevented a dramatic increase in the number of individuals subject to the alternative minimum tax (AMT)--essentially a parallel federal income tax system with its own rates and rules. The last such patch expired at the end of 2011. Unless new legislation is passed, your odds of being caught in the AMT net greatly increase in 2012, because AMT exemption amounts will be significantly lower, and you won't be able to offset the AMT with most nonrefundable personal tax credits.

Other provisions that have already expired:

- *Bonus depreciation and IRC Section 179 expense limits*-- If you're a small business owner or self-employed individual, you were allowed a first-year depreciation deduction of 100% of the cost of qualifying property acquired and placed in service during 2011; this "bonus" depreciation drops to 50% for property acquired and placed in service during 2012, and disappears altogether in 2013. For 2011, the maximum amount that you could expense under IRC Section 179 was $500,000; in 2012, the maximum is $139,000; and in 2013, the maximum will be $25,000.
- *State and local sales tax*-- If you itemize your deductions, 2011 was the last tax year for which you could elect to deduct state and local general sales tax in lieu of state and local income tax.
- *Education deductions*-- The above-the-line deduction (maximum $4,000 deduction) for qualified higher education expenses, and the above-the-line deduction for up to $250 of out-of-pocket classroom expenses paid by education professionals both expired at the end of 2011.

What's expiring at the end of 2012?

After December 31, 2012, we're scheduled to go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%). The rates that apply to long-term capital gains and dividends will change as well. Currently, long-term capital gains are generally taxed at a maximum rate of 15%. And, if you're in the 10% or 15% marginal income tax bracket, a special 0% rate generally applies. Starting in 2013, however, the maximum rate on long-term capital gains will generally increase to 20%, with a 10% rate applying to those in the lowest (15%) tax bracket (though slightly lower rates might apply to qualifying property held for five or more years). And while the current lower long-term capital gain rates now apply to qualifying dividends, starting in 2013, dividends will be taxed at ordinary income tax rates.

Other provisions expiring at the end of the year:

- *2% payroll tax reduction*-- The recently extended 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax expires at the end of 2012.
- *Itemized deductions and personal exemptions*-- Beginning in 2013, itemized deductions and personal and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs).
- *Tax credits and deductions*-- The earned income tax credit, the child tax credit, and the American Opportunity (Hope) tax credit revert to old, lower limits and (less generous) rules of application. Also gone in 2013 is the ability to deduct interest on student loans after the first 60 months of repayment.

New Medicare taxes in 2013

New Medicare taxes created by the health-care reform legislation passed in 2010 take effect in just a few short months. Beginning in 2013, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for high-wage individuals. Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals.

Who is affected? The 0.9% payroll tax increase affects those 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). The 3.8% contribution tax on unearned income 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).

New 401(k) Plan Disclosure Rules

In October 2010, the Department of Labor issued new regulations that require all self-directed 401(k) plans--both those that choose to comply with ERISA Section 404(c) and those that do not--to provide the same detailed information to participants about the plan and its investments, on a regular and periodic basis, so that participants can make informed decisions with regard to the management of their individual accounts.

You may have heard about new disclosure rules that will soon apply to 401(k) plans. Before describing what's ahead, however, a look back may be helpful. (While we'll refer to 401(k) plans in this article, the new rules also apply to other employer-sponsored plans that allow participants to direct their own investments, commonly referred to as "self-directed plans.")

Background

Most 401(k) plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA) (governmental plans, owner-only plans, certain 403(b) plans, and certain church plans are not). One of the primary reasons Congress enacted ERISA was to protect retirement plan assets, and one of the important ways ERISA does so is through its rules governing the conduct of plan fiduciaries.

In general, plan fiduciaries include the plan administrator, anyone providing investment advice for a fee, and anyone who exercises discretionary authority or control over the plan or the plan's assets. Plan fiduciaries must discharge their duties with respect to the plan prudently, and solely in the interest of participants and beneficiaries.

A fiduciary who breaches his or her duty to the plan may be personally liable for any losses that occur as a result of that breach. The investment of plan assets is a fiduciary act governed by ERISA's fiduciary standards.

Section 404(c) plans

But who is responsible for losses in a self-directed plan, where the participants themselves, and not the plan sponsor or an investment manager, select the investments for their retirement accounts? To answer this question, in 1992 the Department of Labor (DOL) issued regulations that allow 401(k) plan fiduciaries to avoid responsibility for losses in self-directed plans that occur as a result of a participant's exercise of investment control over his or her own account, if specific requirements are satisfied.

To avoid liability, self-directed plans must provide participants with a diversified choice of investments, and must disclose very specific information about the plan and its investments (and comply with certain other requirements). While these rules are voluntary, many (if not most) 401(k) plans choose to comply, in order to shift liability for losses away from the plan's fiduciaries.

A 401(k) plan that complies with these rules is known as a "Section 404(c) plan," after the section of ERISA that governs self-directed plans. A plan's summary plan description (SPD) should indicate if the plan intends to be a Section 404(c) plan.

What's changing?

As self-directed plans have grown more popular, the DOL has become increasingly concerned that participants might not have access to, or might not be considering, information critical to making informed decisions about the management of their accounts--particularly information about investment choices, fees, and expenses.

As a result, in October 2010, the DOL issued new regulations that require all self-directed 401(k) plans--both those that choose to comply with Section 404(c) and those that do not--to provide the same detailed information to participants about the plan and its investments, on a regular and periodic basis, so that participants can make informed decisions with regard to the management of their individual accounts.

Some information must be provided on an annual basis, and some information must be provided quarterly. For calendar year plans, the initial annual disclosure must be furnished no later than August 30, 2012. The first quarterly statement must be furnished no later than November 14, 2012 (for July through September 2012).

Participants in 401(k) plans that comply with ERISA Section 404(c) are already receiving most of the information required by the new regulations. In general, more detailed information about investment fees and expenses must now be disclosed to participants.

Another change is that plan investment information must now be provided in chart form, so that participants are better able to compare investment alternatives. And plans will no longer be required to automatically provide a prospectus to participants, although one must be provided upon request.

Which plans must comply with the new rules?

These new disclosure rules apply to 401(k) plans and other plans that allow participants to direct their own investments, but they don't apply to IRAs, SEPs, or SIMPLE IRA plans. They also don't apply to plans that aren't covered by ERISA.

Korbitz Financial Planning LLC
Eric S. Korbitz, CPA, CFP®
PO Box 170049
Milwaukee, WI 53217
414-979-1040
eric@korbitzfinancialplanning.com
www.korbitzfinancialplanning.com

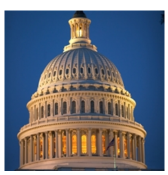
What happens to my retirement benefits if my employer goes out of business?

If your employer goes out of business, any retirement plan your employer sponsored will be terminated. If the plan is a 401(k) or other defined contribution plan, your benefits are held in trust, apart from your employer's assets, and you'll generally be entitled to receive your full account balance in a lump sum. (You can take the cash, or roll your payout into an IRA or another employer's plan.)

But if your employer sponsors a defined benefit plan, it gets a little more complicated. A defined benefit plan promises to pay you a specific monthly benefit at retirement. While defined benefit plan assets are also held in trust (or insurance contracts), apart from your employer's assets, whether a particular plan has enough cash to pay promised benefits depends on your employer's contributions and the plan's investment earnings and actuarial experience.

When a defined benefit plan is about to terminate, the Pension Benefit Guaranty Corporation (PBGC), a federal agency created specifically to protect employees covered by these plans, is notified. If the plan has enough money to cover all benefits that participants have accrued up to the plan termination date, then the PBGC will permit a "standard termination," and your employer will either purchase an annuity from an insurance company (which will provide lifetime benefits when you retire) or, if your plan permits, let you choose a lump-sum equivalent.

However, if the plan doesn't have enough money to pay all promised benefits earned up until plan termination (that is, the plan is "underfunded"), the PBGC will take over the plan as trustee in a "distress termination," and assume the obligation to pay basic plan benefits up to legal limits. For plans ending in 2012, the maximum annual benefit (payable as a single life annuity) is $55,840 for a worker who retires at age 65. If you begin receiving payments before age 65, or if your pension includes benefits for a survivor or other beneficiary, or if your plan was adopted (or amended to increase benefits) within five years of the termination, the maximum amount is lower. According to the PBGC, only 16% of retirees in recent years have seen their benefit reduced because of the annual dollar limits.



What is the Pension Benefit Guaranty Corporation?

The Pension Benefit Guaranty Corporation (PBGC) is a federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to help protect pension plan benefits. When a pension plan ends (a "plan termination") without enough money to pay all benefits owed to participants, the PBGC takes over and assumes the obligation to pay those benefits.

The PBGC only protects defined benefit plans--that is, qualified employer pension plans that promise to pay a specific monthly benefit at retirement, based on your pay and years of service with your employer. The PBGC doesn't protect 401(k) or other defined contribution plans, plans not covered by ERISA (for example, governmental plans and certain church plans), or plans offered by professional service employers (such as doctors and lawyers) with fewer than 26 employees.

The PBGC guarantees that you'll receive basic pension benefits up to a specified dollar amount. Basic benefits include normal and early retirement benefits, survivor annuities, and disability benefits. The maximum pension benefit is set by law and adjusted yearly. For plans ending in 2012, the maximum annual amount (based on a single life annuity) is $55,840.92 (or $4,653.41 per month) for a worker who retires at age 65. According to the PBGC, most people receive the full benefit they had earned before the plan terminated. However, this amount may be lower than the benefit you had counted on from your plan at retirement.

The PBGC maintains two insurance programs: the single-employer program protects about 33.6 million workers and retirees in about 27,600 pension plans, and the multiemployer program protects 10.4 million workers and retirees in about 1,500 pension plans. (Multiemployer plans are set up by collectively bargained agreements involving more than one unrelated employer, generally in one industry, such as trucking or construction.)

The PBGC isn't funded by general tax revenues. Rather, the PBGC collects insurance premiums from employers that sponsor insured pension plans, receives funds from the pension plans it takes over, and earns money on its investments. Employers are required by ERISA to pay insurance premiums to the PBGC.