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1st Quarter 2013

SA-KG ADVISORS QUARTERLY

7 Major Tax Changes In The Fiscal Cliff Law

From the edge of the "fiscal cliff," Congress took a step back and approved the American Taxpayer Relief Act (ATRA), a hodgepodge of tax extensions and modifications. But the agreement postponed decisions on spending cuts and failed to continue a 2% "payroll tax holiday" for employees. Moreover, upper-income taxpayers will have to shoulder a greater burden going forward. Here are seven noteworthy changes for individuals.

1. Individual Tax Rates. Across-the-board tax hikes are averted and the "marriage penalty" is eased. Nevertheless, ATRA creates an "extra" top tax rate of 39.6% for single-filers with income above $400,000 and joint-filers with income above $450,000. When you add in the new 3.8% Medicare surtax for certain upper-income investors, which begins in 2013, your effective top tax rate can reach 43.4%!

2. Capital Gains And Dividends. The "Bush tax cuts" for capital gains and dividends are generally preserved. The maximum tax rate remains 15% for net long-term capital gain and qualified dividends (0% for investors in the lowest tax bracket). Otherwise, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket). Even worse, dividends would have been taxed at ordinary income rates. But the upper crust still pays a steep price: a maximum 20% tax applies to single-filers with income above $400,000 and joint-filers with income of more than $450,000.

3. Alternative Minimum Tax. The onerous alternative minimum tax (AMT), which has steadily been casting a wider net each year, is overhauled. Under ATRA, exemption amounts have been increased and nonrefundable personal credits can be used to offset AMT liability in full. In addition, the exemption amounts will be indexed for inflation in the future. Because the changes are retroactive to the 2012 tax year, it's been estimated they will save as many as 60 million taxpayers from the clutches of the AMT.

4. Itemized Deductions And Personal Exemptions. Two other "back-door" tax increases may affect taxes of wealthier individuals. Due to the revival of the "Pease rule," most itemized deductions are reduced by 3% of the amount of adjusted gross income (AGI) above a specified threshold, beginning in 2013 (but the overall reduction can't exceed 80%). At least ATRA establishes higher thresholds of $250,000 for single-filers and $300,000 for joint-filers. A comparable provision begins to phase out the tax benefits of personal exemptions at the same thresholds.

5. Education Tax Breaks. ATRA generally extends several valuable tax incentives relating to higher education. Significantly, it allows parents to claim the maximum $2,500 American Opportunity Tax Credit (AOTC) for another five years, subject to a phaseout based on modified adjusted gross income (MAGI). It also extends the above-the-line deduction for tuition and fees, also phased out based on MAGI, through 2013. This deduction may be claimed in lieu of a higher education credit. The

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Flex Accounts: New Rules Going In, Same Rules Going Out

The rules for taking *distributions* from a flexible spending account (FSA) this year haven't changed. If you don't exhaust your account's 2012 balance by March 15, 2013, at the latest (when permitted), you'll lose any money that's left over. But there's a big change for FSA *contributions* in 2013: The maximum you can use to fund an FSA for health care expenses is restricted by a new dollar cap.

With an FSA, your contributions aren't subject to federal income tax. For instance, if you contributed $5,000 to a health care FSA in 2012 and you're in the 35% tax bracket, you saved $1,750 (35% of $5,000) in tax. That's an employee benefit that's hard to pass up. Some companies also provide FSAs for dependent care expenses.

You don't have to pay tax on FSA withdrawals used for qualified expenses. But there's a "use it or lose it" feature. You'll forfeit amounts left in the FSA at the end of the year, although your company may allow a two-and-a-half-month grace period.

Previously, there was no limit on the contributions allowed for a health care FSA. (The limit for dependent care FSAs is $5,000.) However, under the Affordable Care Act of 2010 ("Obamacare"), contributions to an FSA for health care expenses can't exceed $2,500, beginning in 2013. Consider both "incoming" and "outgoing" in your FSA decisions.

Avoid These 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 higher income tax and investment tax rates for high-income investors and the arrival of a new 3.8% Medicare surtax in 2013. 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. ●

Take A Closer Look At Your RMDs

The IRS allows you to build up a sizeable nest egg for retirement inside your traditional IRAs. But then the other shoe drops: Whether you want to or not, you must begin taking "required minimum distributions" (RMDs) once you reach a certain age. Otherwise, you could be socked with a hefty tax penalty.

But the tax law does provide some flexibility. Depending on your situation, you might decide to withdraw funds from one of your IRAs, all of your IRAs, or any combination you prefer.

You have to start taking RMDs from your IRAs by April 1st of the year after the year in which you turn age 70½. In other words, if your 70th birthday was on June 1, 2012, you must take an RMD for the 2012 tax year by April 1, 2013. Then you still have to take another RMD for the 2013 tax year by December 31, 2013.

The amount of the RMD is based on the value in your accounts on December 31st of the tax year and is calculated according to IRS-approved life expectancy tables. For example, if you have a total balance of $1 million in your IRAs and your age is 76, the distribution period under the life expectancy table is 22 years. Divide $1 million by 22, and you arrive at an RMD of $45,454.55 for the current tax year.

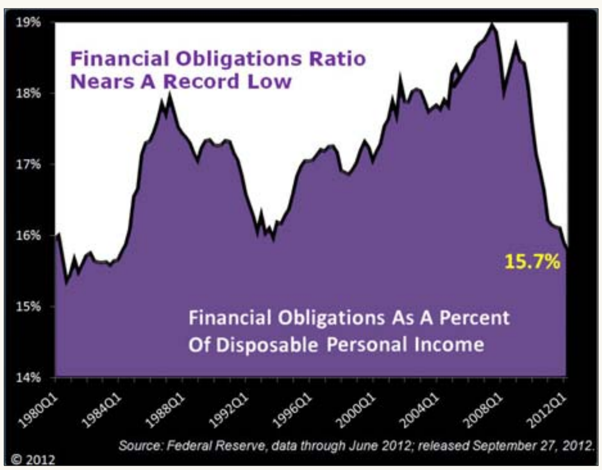
The penalty for failing to take a timely RMD is equal to 50% of the required amount of the distribution (minus any distribution you actually received). Going back to our example, suppose you've taken an RMD for 2012 of $20,454.55, or $25,000 less than the required amount. In this case, you would owe a penalty of $12,500 (50% of $25,000) on top of the regular income tax. If you're in the 35% tax bracket in 2012, that's a whopping total of $28,409 ($15,909 + $12,500)!

Comparable rules apply to tax-deferred earnings within a tax-qualified

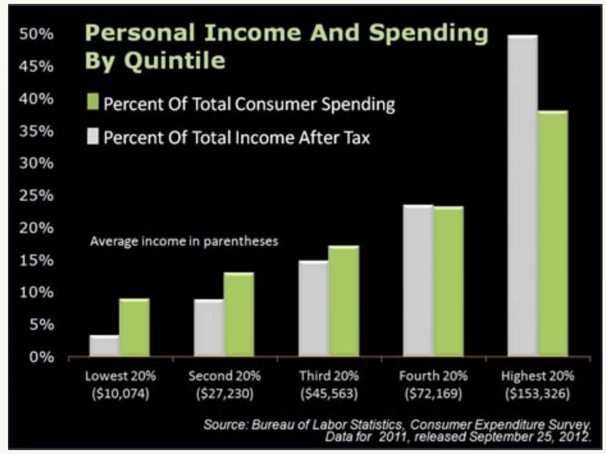
Top Income-Earners Driving U.S. Growth

Have you been surprised by the slow but steady growth in the U.S. economy over the last three years and the accompanying doubling in U.S. stock prices in major indexes of the broad stock market? The explanation for these two very positive economic developments may lie in the distribution of income and spending in America, specifically in their skew toward wealthier individuals. To be clear, it's not the top 1% of wealthiest Americans driving the recovery but the top two income quintiles, the middle class — the top 40%.

The top two income quintiles account for 61% of total spending in the U.S. economy, according to statistics released in September 2012 by the U.S. Bureau of Economic Analysis. The bottom two quintiles account for just 22% of total spending.



The top 40% of income earners in the U.S are in good enough financial condition to spend at a level sufficient to fuel slow growth, and recent economic reports indicate that this is likely to continue. Consider the following:



Auto Sales are recovering from the dismal period in 2008 and 2009. Because car sales collapsed during the recession, rising demand for new cars is likely to continue. "Cars have a limited useful life," says Fritz Meyer, an independent economist, "and the age of the fleet should propel new sales in the months ahead."

Housing Starts have rebounded strongly since the recession. The U.S. population increases by about three million a year, according to the U.S. Census Bureau. As a result, the nation needs about 1.5 million housing starts annually, Meyer says. In the years leading up to the recession — the housing bubble of 2005 and 2006 — housing starts soared to nearly two million. After the bubble burst and the recession took hold, housing starts plunged in 2009 to a low of about 400,000 annually. Since then, however, a recovery has pushed the rate to about 700,000 housing starts. Mortgage Bankers Association forecasts, along with the long-term population growth trend, support the case for a continued recovery in housing.

Household Balance Sheets are about as strong as ever. The Federal Reserve's financial obligation ratio, which measures consumers' fixed expenses compared to disposable income, has fully recovered since the recession. At 16%, households have 84% of after-tax income with which to make purchases.

"Consumers' ability to cover their monthly 'nut' has seldom been better," according to Meyer. "As incomes have recovered, household debt has been reduced and interest rates remain low."

The financial obligations ratio consists of estimated required payments on outstanding mortgage and consumer debt plus automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance and property tax payments divided by disposable personal income.

The data on the top two income quintiles does not address whether wealth in America is more concentrated. But it does debunk the myth that the top 1% controls the American economy. It also shows, unfortunately, that individuals in the lowest income quintile are finding it difficult to meet expenses. Still, it is comforting to know that the nation's economy and the rise in corporate earnings behind the stock market's three-year rebound are driven by a broad demographic group, and their ability to continue to fuel a slow-growth recovery appears fundamentally sound. ●

retirement plan such as a 401(k). But you may postpone RMDs from qualified plans (not IRAs) if you continue working past age 70½ as long as you don't own more than 5% of the company that employs you.

The amount of your annual RMD reflects the value of all your IRAs, but you can actually withdraw the funds from one or more of the IRAs. If you're maintaining separate IRAs with different beneficiaries, you might want to keep the balances in all of them equal—and they may have gotten out of whack because of withdrawals, contributions, fees, and investment performance. So, for instance, if you have three IRAs and you've designated a different beneficiary for each one, you could withdraw the entire RMD amount from the IRA with the highest balance. Or you could get rid of underperforming assets in one of your accounts by liquidating those to provide cash for the RMD.

Keep in mind that you must give explicit instructions about your RMDs to each IRA custodian, and please call us if you have any questions. ●

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tuition deduction extension is retroactive to 2012. Finally, ATRA permanently extends enhancements for Coverdell Education Savings Accounts (CESAs), the tax exclusion for employer-provided education assistance and the student loan interest deduction.

6. Extensions Of Other Rules. Besides those already mentioned, ATRA extends a host of other tax provisions for individuals, many of them retroactive to the beginning of 2012 (i.e., for provisions that technically expired). Most of the extended tax breaks are limited by dollar amounts. The list includes:

- Optional state sales tax deduction (in lieu of state income tax)
- Enhanced child tax credit, dependent care credit and adoption credit (and tax exclusion for adoption program assistance)
- Credit for energy-saving at home
- Monthly tax exclusion for certain commuting benefits
- Deduction for mortgage insurance premiums
- Deduction for classroom expenses of educators
- Tax exclusion for mortgage debt forgiveness
- Tax benefits for donating real estate for conservation purposes
- Tax-free distributions of IRA funds to charity by those age 70 ½ or over

7. Estate And Gift Taxes. At long last, there's greater certainty in estate planning. Beginning in 2013, the unified estate and gift tax system permanently retains a $5 million exemption and will be indexed annually for inflation ($5.25 million in 2013), instead of plummeting from $5.12 million in 2012 to $1 million. The top estate tax rate, which was scheduled to jump from 35% in 2012 to 55% in 2013, is bumped up to 40%. ATRA also retains the provision allowing "portability" of estate tax exemptions between spouses and coordinates various other aspects, including implementation of the generation-skipping tax.

These are just some of the highlights of the fiscal cliff law. We will be offering further guidance on the tax law changes, but please don't hesitate to call us about how the changes affect you personally. ●

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