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THIS ISSUE...

Congress...What's My Tax Bill?

Chris Sutherland, CPA

In our last edition, John Slayton outlined several pending changes to the tax code that are scheduled to take effect in 2013. Most of those changes will take place if Congress does not act to either change or extend the current law. As in 2010, most expect Congress will simply extend the current law through 2013. But, there is a chance that an extension will not apply to all taxpayers.

President Obama would like the Bush tax cuts to expire for upper-income taxpayers ($250,000 for joint filers), but is likely setting up for a compromise. The November elections will play a big factor in how the compromise plays out.

The nonpartisan Congressional Budget Office (CBO) said recently that the pending tax hikes and spending cuts scheduled to take effect in January would take $607 billion out of the economy next year, which could lead to another recession. The alternative, extending the tax cuts, would lead to stronger near-term growth, but would likely increase the national debt and compound our future economic problems.

So, exactly what Congress will do is still unknown and certainly will be debated until they take action. Here are a few things to think about as the summer passes and we approach the close of 2012:

>> **Capital Gains** – Rate scheduled to increase from 15% to 20%. Let's assume you have a $50,000 unrealized gain. The federal tax on that gain would be $7,500 this year compared to $10,000 if realized next year. In order to net the same after tax, your investment would need to return over 40% the following year. This is a simple example and changes as your holding period increases. The longer you hold the investment, paying taxes up front (even at a lower rate) becomes less attractive.

>> **Medicare Surcharge** – 3.8% surtax beginning in 2013. As part of President Obama's healthcare law, individuals and trusts may have to pay a surtax of 3.8% on certain types of unearned income. Joint filers will be subject to the tax if your modified adjustable gross income exceeds $250,000. Trusts will be subject to the surtax if they are in the highest tax bracket ($11,200 in 2013). The surtax is yet another reason to possibly realize capital gains in 2012.

Continued on back cover

NOTABLE QUOTE

"Our problems are man-made, therefore they may be solved by man. And man can be as big as he wants. No problem of human destiny is beyond human beings."
– John F. Kennedy, June 30, 1963

Storm-Proof Your Possessions and Finances

by John Slayton, CFP®

As we proceed through hurricane season this year, let's take a moment to focus on our actual level of preparedness against life's risks. Too often we assume we are adequately insured, only to learn the contrary at the time of a cataclysmic loss. Denial of what could happen in a natural disaster does not make it any less likely to occur, but it could make it potentially more devastating than it need be. Insurance may not be at the top of your discussion list, but when is the last time you had a conversation with your insurance agent regarding the adequacy of your home and possessions coverage? Here are some points to consider and discuss…

>> Be sure your losses will be reimbursed based on the preferable (and more expensive) *"replacement cost basis"*- replacing the property at current prices, rather than the "actual cash value"– the depreciated value of the property at the time of loss.

>> Experts estimate that up to *64% of American homes are underinsured by an average of 27%.* Make sure your coverage is adequate to *reflect improvements* you have made or *market price increases.* Have your house re-appraised, if necessary.

>> Increase your deductible to the lowest amount for which you would actually file a claim against your homeowner's policy. If you would absorb any loss up to $1,000 before filing with the insurance company and risking cancellation or premium hikes, your deductible should be $1,000.

>> Make sure your *co-insurance clause,* perhaps requiring you to carry coverage of at least 80% of your home's value, is met. If you are underinsured, a penalty kicks in, increasing the more you are underinsured, resulting in exclusions and contents depreciation, and a nasty surprise if you have a significant loss.

>> Ask your insurer what it shows as the *total value of your personal property.* Often it is an estimate the insurance company makes based on the size of your home (number of rooms) and where you live – the insurer assumes you have a certain amount of clothing and other possessions. If you lose everything, the insurer will generally cut you a check for the total estimate they used for your policy coverage, not an item-by-item payment. Walk through your home and add up the cost/value of your possessions. If the insurer's estimate is not in line, have it increased and pay the higher premium.

>> If you are not sure you will be able to remember every possession in every room, with model numbers and serial numbers, after your house is destroyed, *make a videotape.* Video each room, describing contents, opening doors and drawers and filming the back of equipment for the model and serial numbers. Show measurements and describe materials – leather vs. vinyl, original oil vs. print, granite vs. formica, antique vs. reproduction, to help place an accurate value. *Make an inventory,* including date and place of purchase and price. *Keep two copies of the video and inventory in different off-site locales.*

>> **Appraise your collectibles** – art, jewelry, crystal, silver, furs and Persian carpets. Check your policy to confirm that these high priced items are covered. Often they are insured for damage, but not for theft. Also, policies often cap the possessions coverage at fifty percent of the house coverage. Insure these high-priced items on *a personal articles rider to your home policy.* This coverage is reasonably priced, but each article must be inventoried and valued separately.

>> Make sure *everything you own is covered.* Many hurricane victims were surprised to learn that damage to pools and docks was not covered by their policies. *How about your home office?*

>> **Flood insurance** is crucial, even if you do not reside in an apparent flood zone. Federal Emergency Management Agency estimates 25% of all flood claims occur in low- to moderate-risk areas. Insurance for homeowners and renters does not cover flood damage. At an average premium of $400 for approximately $100,000 of coverage, it is a good investment. If you have flood insurance, make sure you have full possessions coverage. Plan in advance – there is a 30 day waiting period and, in some areas, no new policies are written once the hurricane season begins.

>> Put together a *lockable evacuation* box to keep with you if you must evacuate, and place the following in it in waterproof bags:

Continued next page

A special "Thank you" to all the panelists, speakers and guests that helped make our inaugural Day of Discovery Symposium a huge success!

My Shrinking Circle of Competence

by Mike Palmer, CFP®

Over the last month I've been reminded about the concept of "circle of competence" and the benefits of knowing what I don't know. As Memorial Day approached I was occupied with getting our lake house in order for the upcoming season. This included irrigation system maintenance, some routine maintenance on our jet ski, and some minor home repairs.

My wife can attest that I'll never be a candidate to replace Bob Villa as host of This Old House, but I like to think of myself as reasonably intelligent, capable of following directions and not a danger to myself or others with a screwdriver. How hard can it be, right?

But in a world of increasing complexity, my ability to tackle these projects confirmed that my circle of competence is shrinking and that in fact trusting those with experience and expertise is usually the best choice. After spending the better part of a day troubleshooting a jet ski only to discover that the problem was simply a blown fuse, I accepted that perhaps I'd be better off hiring experts for the irrigation and home repair projects. This proved to be the wise choice.

The landscape of personal finance is much like a vacation home; there are nearly endless pitfalls that can waylay the "do-it-yourselfer." And often times it is one's not knowing what they don't know that is most dangerous. Whether it's managing an investment portfolio, determining appropriate insurance coverage, or analyzing the adequacy of an estate plan our expertise and experience help our clients navigate an increasingly complex world.

Continued from page 2

- At least $500 cash, in small bills.
- Copy of the home inventory and videotape discussed earlier.
- Any significant documents not already stored in a safe deposit box, such as birth and marriage certificates, passports, legal documents, deeds, securities, car titles and insurance policies.
- Safe deposit key.
- Significant business records and computer disks or memory sticks.
- A list of all financial accounts, loans, credit cards and related contact information.
- The first two pages of the previous year's tax returns.
- Checkbook and postage stamps.
- Disposable camera to photograph damage.

>> Make sure you have adequate ***umbrella liability coverage*** to protect against a devastating liability judgment against any family member.

No one likes to focus on mundane insurance issues, but it is preferable to get your coverage right today, rather than discovering it is inadequate after a catastrophe. Call us so we can schedule a discussion with your insurance agent and BE CAREFUL OUT THERE.

Continued from cover

- >> **Roth Conversion** – If you have been considering converting your Traditional IRA to a Roth IRA, 2012 might be a good time. Tax rates are scheduled to increase next year with the top rate moving from 35% to 39.6%. In addition to the potential tax savings upon conversion, future distributions are tax free and there are no required minimum distributions at age 70 ½. Additionally, Roth distributions are not included in adjustable gross income which could increase deductions and help avoid the previously discussed Medicare surtax.
- >> **Estate and Gift Exemptions** – Time is running out on popular techniques. Both the estate and gift tax exemptions are $5,120,000 for 2012, but both are scheduled to revert back to $1,000,000 in 2013. Keep a close eye on what Congress does with this law. You may not have another chance during your lifetime to transfer wealth at this level.

In addition to the exemption amounts, President Obama would like to eliminate many of the leveraged gifts that have become popular over the past decade.

- >> **Grantor Retained Annuity Trust (GRAT) Limitations** – A GRAT names the grantor as the sole beneficiary for a set period of years during which the trust must make annuity payments to the grantor. At the end of the term, the remaining value of the trust passes to secondary beneficiaries (presumably children of the grantor). The annuity amount is determined by current interest rates. Because the grantor must outlive the trust for it to be an effective wealth transfer strategy, most GRAT terms are short, as little as 2 years. President Obama has proposed a 10 year minimum term which would dramatically reduce the appeal.
- >> **Discount Valuation Limitations** – Whether through gifting or sale, valuation discounts have been used often with transfers of partnership interests. New legislation could eliminate the use of minority interest discounts with investment holding companies, significantly impacting the amount of wealth transferred to children free of estate tax.
- >> **Dynasty Trusts** – In addition to gift tax, there is also a generation skipping tax (GST) imposed on gifts to a "skip person", which is a person who is two generations (or more) younger than the donor. Like both the estate and gift tax, the GST exemption amount is currently $5,120,000, but is scheduled to revert back to $1,000,000 in January. By making a gift to a GST tax-exempt dynasty trust the transfer is only subject to tax at the initial transfer. The wealth accumulated and transferred thereafter avoids both estate and GST tax while the trust is active.

There are many different aspects of the tax code and many participants will shape the landscape over the coming months and years. The Supreme Court will be ruling on the healthcare act and Congress will have to make tough decisions on current and future legislation that will impact our economy for years.

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