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FINANCIAL CONCEPTS

SPRING 2014

2013: The Year of Higher Taxes

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012, and the next day, President Obama signed it into law. What relief the act gives is to low- and middle-income households, largely by extending the Bush-era rates on income taxes and capital gains (although everyone lost the two-year, two-percentage-point reduction in payroll taxes). The law keeps intact the rates on the lower six brackets (10%, 15%, 25%, 28%, 33%, and 35%). But the flip side of extending tax relief to the proverbial "99%" of income earners is raising the tax bill for higher income earners.

Dear Friends, Family, and Clients,

Five years ago, I wrote about the green shoots of the world economies starting to sprout. It now looks like we are beginning to see signs of more healthy, self-sustaining plants. Certainly, the harvest of stock market returns in these past years has been exceptionally bountiful!

Leaving the plant growing analogies aside, equity prices, in general, are not as cheaply priced as they once were. If we have not done so recently, let's review your overall asset allocation to make certain that we are properly positioned to take advantage of opportunities as they may arise.

Enclosed with this newsletter is our *2014 Tax Guide*. Much has changed. Please take a quick look at the gifting amounts, deductible levels for 401(k)s, capital gains, and estate tax rates. It is a good reference piece to keep handy.

Wishing you a sunny, warm, and prosperous spring,

Peter

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The views expressed by the author are his own and do not necessarily reflect the opinion of Wells Fargo Advisors or its affiliates. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

What the Taxpayer Relief Act Means

- **A new highest income tax bracket.** The Act reestablishes the 39.6% Clinton-era tax bracket for the highest incomes. It applies to single filers with taxable income of $400,000 or more and married couples who file jointly and have taxable income of at least $450,000. As unpopular as the very idea of raising taxes is, it's important to keep in mind that the new highest income tax bracket is below the century-long average of just over 59% (Source: Tax Foundation, 2013). Secondly, it's a marginal rate, which means that the effective income tax rate is weighted for lower levels of income taxed at lower rates. Finally, the effect of the Act is to lower taxes or keep them flat for most Americans.
- **Higher taxes on capital gains and investment income.** While the Act retains the favorable long-term capital gains tax rate of 0% for those in the lowest two income brackets and 15% for the middle-income brackets, it raises it to 20%

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2013: The Year

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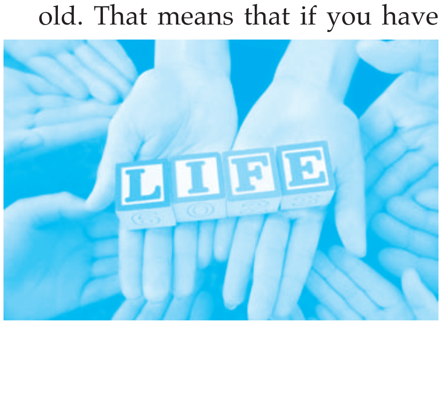
for households in the new 39.6% bracket. The law also ushers in a new net investment income surtax tax of 3.8% for single filers with adjusted gross income above $200,000, and for married couples filing jointly, above $250,000. The surtax, designed to support Medicare, applies to dividend and interest income, rent, royalty, annuity, and trust income in addition to capital gains.

❍ **Higher Medicare payroll tax rate.** In addition to the Medicare surtax, under the new law, an additional Medicare payroll tax of 0.9% applies on income above $200,000 for single filers and above $250,000 for married couples filing jointly.

❍ **Limits on itemized deductions and personal exemptions.** By reinstating these limits — suspended the last two years — the new tax law exposes more of high-earners' income to taxation. Broadly called the Pease limitation for the Congressman who proposed it in the 1990s, it phases out the ability to take personal exemptions and limits the ability to take the full amount of itemized deductions for single filers with $250,000 or more and married couples filing jointly with $300,000 or more in taxable income. The tax code allows most Americans to claim a $3,900 exemption for themselves, their spouses, and dependents. But under the new law, the value of personal exemptions is reduced by 2% for every $2,500 of taxable income above the relevant threshold. That means that if you have taxable income of $125,000 above those thresholds, the personal exemption is zeroed out. As for itemized deductions, they apply to every category except medical expenses. The limit kicks in at the applicable thresholds, and limits those filers to the lesser of the results of either a reduction in the itemized deductions of 3% of adjusted gross income above the threshold or 80% of the deductions.



❍ **Higher estate tax rate.** The new tax law raises the federal estate and gift tax rate from 35% to 40% and sets the threshold for taxability at $5,000,000. That threshold is now permanently indexed for inflation, with the limit set at $5,250,000 for 2013.

Not every feature of the act is more costly for high-income households. For one thing, it indexes the alternative minimum tax threshold to inflation, and it extends the portability of a spouse's unused estate tax and uniform gift exclusion to the surviving spouse's estate. Nevertheless, the new tax law may necessitate a variety of changes in your tax strategy.

Now is the time to begin mapping out your strategies to minimize their bite. Please call if you'd like to discuss this in more detail. ❍❍❍

A Financial Plan Is a Living Document

How often should you revise your plan? The easy answer is this: whenever there's a major change in your life circumstances. The truth is, though, even without those major events, an annual review is a good idea. Let's take a closer look at what you'll need to pay periodic attention to:

Family changes. These include the births or adoption of children, marriage or divorce, and changes in your health or that of your partner or spouse.

Career and income changes. If you're promoted and your income increases or you change careers or lose your job, your current lifestyle is likely to change and you might need to reset your goal for your retirement too.

Changes in tax rates and tax laws. Over the past decade, taxation has been a particularly volatile subject, with federal and state income and investment taxes changing and big swings in estate tax provisions. These can have a major effect on the value of any strategy you may have in place.

Potential changes in Social Security and health insurance. The Affordable Care Act, passed in 2010, is restructuring the health care insurance market, and most of its provisions have yet to take effect. As for Social Security, to date, its benefits are linked to the rising cost of living, so it's important to stay on top of your projected benefits year by year.

Market returns. Market volatility can wreak havoc with your plans for the future. Even without major gyrations in the markets, it pays to review the investment and asset components of your financial plan at least once a year. Even the best plans are based on an estimate of future rates of return. As result, it's more often that your actual returns will vary than that they'll hit your projections exactly.

What's important is to check your progress toward your long-term goals and remember that you're more likely to be in a marathon toward your goals than a sprint. It can be a mistake to let your financial plan sit too long unattended. Much has changed in just the past few years. If you feel it's time to give your plan another look, please call. ❍❍❍

The Role of Life Insurance in Estate Planning

A quick review of the uses and advantages of life insurance will introduce you to some of the many ways in which this flexible financial tool can help you and your family.

An instant estate — Generally speaking, life insurance first becomes useful when you start a family. At that point, most people have little in the way of assets, but the long-term needs for dependents can be great. With the first payment of a premium on a life policy, you can instantly create an estate with a substantial value for your family to meet a variety of needs.

Rapid liquidity — Unlike most other assets, life insurance proceeds can avoid probate. Instead, after filing a claim, beneficiaries can usually receive payment in 30 days or less.

Income-tax free transfers — Generally speaking, life insurance proceeds, both to a surviving spouse and all other beneficiaries, are exempt from income taxes. Don't confuse this, however, with liability for federal and state estate taxes. If you're both the policy's owner and insured and the death benefits push your estate above the limit for exemption, estate taxes will be due on the amount over the limit. If the policy is properly set up, however, estate taxes can also be avoided.

Offset estate taxes — For large estates, life insurance can provide an instant source of funds to offset estate taxes, which can be sizable. The threshold for U.S. estate taxes in 2013 is $5,250,000 per person, with a maximum estate-tax rate of 40% for amounts beyond that threshold. But for the price of a considerably smaller premium, you could retain that value through a life insurance policy.

Donate to charity at little cost to heirs — Many people who would like to make gifts to their alma maters or to charitable causes run into a dilemma: whatever they give away while they're alive won't be available for their heirs. Life insurance provides a solution similar to that for offsetting estate taxes: for the relatively smaller cost of the premium, you can give a sizable charitable gift without taking much away from your heirs.

Securing a business interest — If you're a part owner in a business, when you die, your partners may not have the cash to buy out your share of the business. The result may mean an heir who doesn't want to take your place in the company could be stuck with an illiquid asset. One answer is a group insurance first-to-die policy that pays out a benefit when the first member of the group dies. With the surviving partners named as the beneficiaries, the payout can give them the funds to buy out your share.

Please call if you'd like to discuss this in more detail. ❍❍❍

Make Saving a Habit

Habits are all about the principle of human inertia — we tend to keep doing what we've always done, and shy away from doing something new. Once you gain some momentum with your new saving habits, it will be relatively easy to keep it up. If you haven't started saving or aren't saving enough, here are some tips:

- ❍ **Take full advantage of payroll saving plans.** Payroll deduction is a great financial innovation. With one authorization form, you can start a savings program that works for you without any more effort on your part. It doesn't matter what type of plan it is or how much you put in. Just get started and you have a new habit.
- ❍ **Aim to max out your company match.** When a company offers you a matching contribution, it's like they are saying, "Here's some free money. Want it?" Make sure you contribute enough to get the full matching contribution.
- ❍ **Treat saving as a bill.** The old adage for saving is, "Pay yourself first." The trick is to treat saving like any other bill. Name an amount and a date to pay it, then make the payment when it comes due.
- ❍ **Set annual goals for account balances.** You can never reach a goal if you don't have one. Specific annual targets for your account balances become incentives to save; and by dividing the difference between your current balance and your target, you can easily derive the periodic amount you need to contribute.
- ❍ **Devote your raises to saving.** When you get a raise, don't forget to increase your savings. If you can afford to, bank the entire raise. If you can't do that, at least increase your savings by a portion of the raise.
- ❍ **Save your loose change.** Keep a savings jar, and at the end of the week, put your loose change in it. You may also want to put bills below a specific denomination in the savings jar. At the end of the month, deposit the money in savings.

The tips above can take some of the pain out of creating a new habit or adjusting an existing one to help you pursue your goals. ❍❍❍

Does Long-Term-Care Insurance Make Sense?

Over the last 10 years, as costs for care skyrocketed and interest rates on their invested funds declined, insurers' finances became squeezed. In addition, the industry overestimated how many people would let their policies lapse and were paying out more in benefits on more policies than they expected.

As a result, 10 of the 20 biggest providers of LTCI dropped out of the market over the last five years, and many of those who remained significantly increased premiums — already running between $1,000 and $3,000 a year per person — both for existing and new policies. The average policy purchased last year cost 17% more than the same policy the year before, with a healthy 60-year-old couple paying $3,355 a year for a policy that would pay out a total of $340,000 in benefits. In many cases, LTCI premiums must be paid even when policyholders start receiving benefits.

With millions of consumers feeling themselves priced out of the market, sales of new LTCI policies have declined every year through 2012. According to the AARP, as of 2010, just 7–9 million people had private long-term-care insurance in the United States. Since Medicare doesn't cover nursing home or assisted-living expenses, that leaves millions of Americans to fend for themselves or rely on Medicaid, which will cover those kinds of expenses only when personal assets are exhausted.

If the price seems more than you can afford — or want to pay — consider these alternatives:

Customize your policy to lower the premium. There are a number of ways you can reduce the premium of an LTCI policy. These include:

- Reducing total payable benefits, either by reducing the amount of your designated daily benefit or the number of years the policy will cover you.
- Taking out a shared policy that covers you and your spouse for a set number of years for both of you together instead of an equal number of years for each of you.
- Reducing or eliminating the policy's annual inflation adjustment provision.
- Lengthening the time period before you start receiving benefits. Typically, your choices range from 30 to 180 days.

Increase your savings. This works whether you decide to go it alone for long-term care or as a way of supplementing a smaller LTCI policy. If you decide at age 45 to save $3,000 more a year and earn 4% a year on those savings, you could have more than $138,000 by age 70. While that might not go very far in paying for long-term-care expenses, it would help. In addition, it's money you would still have if neither you nor your spouse need long-term-care services.

Tap into home equity. If you have significant equity in your home by the time you or your spouse need long-term care, consider drawing on it by selling your home or taking out a second mortgage or a reverse mortgage to help cover expenses.

Preserve your retirement capital. If you can afford it, live only on interest, dividends, and capital gains in retirement, preserving your capital to cover possible long-term-care expenses.

Take out a "hybrid" policy. These are policies that combine both life and long-term-care insurance, and the premiums can be cheaper than two separate policies for each purpose.

Add a long-term rider to your life insurance policy. These riders enable you to use death benefits while you're still alive to defray costs associated with chronic illnesses.

Please call if you'd like to discuss this in more detail. ❍❍❍

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MARKET DATA

Indicator	Month-end Dec-13	Jan-14	Feb-14	Dec-12	Feb-13
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.43	0.41	0.41	0.51	0.48
3-month T-bill yield	0.07	0.06	0.05	0.09	0.13
20-year T-bond yield	3.61	3.47	3.42	2.56	2.81
Dow Jones Corp.	3.11	2.96	2.83	2.70	2.61
30-year fixed mortgage	4.21	3.88	3.89	2.81	3.15
GDP (adj. annual rate)#	+2.50	+4.10	+2.40	+0.40	+0.40

Indicator	Month-end Dec-13	Jan-14	Feb-14	% Change YTD	12 Mon
Dow Jones Industrials	16576.66	15698.85	16321.71	-1.5%	16.1%
Standard & Poor's 500	1848.36	1782.59	1859.45	0.6%	22.8%
Nasdaq Composite	4176.59	4103.88	4308.12	3.1%	36.3%
Gold	1201.50	1251.00	1326.50	10.4%	-16.5%
Consumer price index@	233.10	233.00	233.90	0.3%	1.6%
Unemployment rate@	7.00	6.70	6.60	-5.7%	-16.5%
Index of leading ind.@	99.30	99.20	99.50	1.2%	5.5%

— 2nd, 3rd, 4th quarter @ — Nov, Dec, Jan Sources: *Barron's, Wall Street Journal*

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