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Well here we are again, staring another federal fiscal crisis in the face while partisans in Washington stare at each other and wait for the other to blink. As usual, we'll have to wait to see how this works out. Up until the last week, it seemed the markets weren't viewing this round as a real crisis, but in the last few days a little concern is starting to show in declining market indices.

This month's newsletter provides a review of the latest tax act, major governmental benefit programs, and an IRA planning strategy. Hope you enjoy. We'll be on vacation March 6-24 but, as usual, I'll be available by email and will be checking voice mail.

Bruce Heling, CFP CPA

March 2013

The American Taxpayer Relief Act of 2012
Looking Backward and Forward on Entitlement Programs

The "SEPP" Exception to the IRA Premature Distribution Tax

I refinanced my mortgage loan last year. Can I deduct any of the costs associated with refinancing the loan?

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The American Taxpayer Relief Act of 2012



The new year started with some political drama, as Congress passed legislation on January 1, 2013, to prevent the country from going over the "fiscal cliff." The American Taxpayer Relief Act of 2012 (ATRA) permanently extends a number of major tax provisions and temporarily extends many others. The legislation also temporarily postpones major automatic spending cuts that were scheduled to take place at the beginning of the year. Here's what you need to know.

Permanent federal income tax rates

For most individuals, the legislation permanently extends the lower federal income tax rates that have existed for the last decade. That means most taxpayers will continue to pay tax according to the same six tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) that applied for 2012. The top federal income tax rate, however, will increase to 39.6% beginning in 2013 for individuals with income that exceeds \$400,000 (\$450,000 for married couples filing joint returns).

Long-term capital gains and dividends

Generally, the lower tax rates that applied to long-term capital gains and qualifying dividends have been permanently extended for most individuals as well. If you're in the 10% or 15% marginal income tax bracket, a special 0% rate generally applies. If you are in the 25%, 28%, 33%, or 35% tax bracket, a 15% maximum rate generally applies. Beginning in 2013, however, those who pay tax at the higher 39.6% federal income tax rate (i.e., individuals with income that exceeds \$400,000, or married couples filing jointly with income that exceeds \$450,000) will be subject to a maximum rate of 20% for long-term capital gains and qualifying dividends.

Alternative minimum tax (AMT)

ATRA permanently extends AMT relief, retroactively increasing the AMT exemption amounts for 2012, and providing that the

exemption amounts will be indexed for inflation in future years. The Act also permanently extends provisions that allowed nonrefundable personal income tax credits to be used to offset AMT liability.

Estate tax

The new legislation makes permanent the exemption amounts (\$5 million, indexed for inflation) for the estate tax, the gift tax, and the generation-skipping transfer tax--the same exemptions that were in effect for 2011 and 2012. The top tax rate, however, is increased to 40% (up from 35%) beginning in 2013. The Act also permanently extends the "portability" provision in effect for 2011 and 2012 that allows the executor of a deceased individual's estate to transfer any unused exemption amount to the individual's surviving spouse.

Itemized deductions and personal exemptions

ATRA provides that, beginning in 2013, personal and dependency exemptions will be phased out for those with incomes exceeding specified income thresholds. Similarly, itemized deductions will be limited. For both the personal and dependency exemptions phaseout and the itemized deduction limitation, the threshold is \$250,000 for single individuals (\$300,000 for married individuals filing joint federal income tax returns).

No extension of 2% payroll tax reduction

Many workers were surprised when they received their first 2013 paycheck. That's because one thing the new legislation did not do was extend the temporary 2% reduction in the Social Security (OASDI) portion of the FICA payroll tax that expired at the end of 2012. As a result, most workers are now receiving about 2% less in take-home pay.

Other provisions

The new legislation extends a host of other tax provisions that had expired--some are extended permanently, others temporarily. For more information, contact a tax professional or visit www.irs.gov.

Looking Backward and Forward on Entitlement Programs



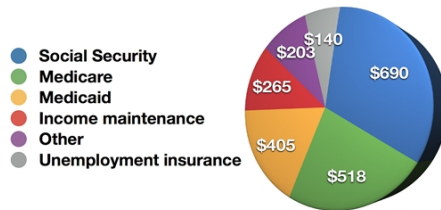
An unsustainable path

The bipartisan Bowles/Simpson Deficit Reduction Commission stated that "our nation is on an unsustainable fiscal path" in regard to entitlement spending.

Last year's presidential election, along with the more recent fiscal cliff and debt ceiling negotiations, have put the spotlight on our nation's tax policy, deficit, and entitlement programs. For some, entitlement programs are necessary--a social compact for America in an era of longer life spans, the decline of employer-provided pensions and health insurance in retirement, and a widening gap between the haves and the have-nots. For others, the current level of entitlement spending is jeopardizing our country's fiscal health and creating an "entitlement lifestyle." No matter where you stand in the debate, do you know the basic facts on our country's largest entitlement programs?

Where the money goes

All entitlement spending isn't created equal. The "Big Three" of Social Security, Medicare, and Medicaid account for more than two-thirds of all federal entitlement spending. Social Security and Medicare are primarily age-based programs, whereas Medicaid is based on income level. According to the U.S. Bureau of Economic Analysis, in 2010, the federal government spent a total of \$2.2 trillion on entitlement programs, with the Big Three accounting for \$1.6 trillion of this total. The largest expenditure was for Social Security (\$690 billion), followed by Medicare (\$518 billion) and Medicaid (\$405 billion).



A history of growth

Alexis de Tocqueville, the famous French political thinker who traveled to the United States in the early 1830s and wrote about the uniqueness of our young nation's individual self-reliance in his famous book, *Democracy in America*, would likely be surprised to observe the growth in spending on entitlement programs that has occurred in the United States over the past 50 years. According to the Bureau of Economic Analysis, in 1960, U.S. government transfers to individuals totaled about \$24 billion in current dollars. By 2010, that figure was \$2.2 trillion, almost 100 times as much.

Current status

Let's look at our two main entitlement

programs--Social Security and Medicare.

Social Security. Created in 1935, Social Security is a "pay-as-you-go" system, meaning that payments to current retirees come primarily from payments into the system by current wage earners in the form of a 12.4% Social Security payroll tax (6.2% each from employee and employer). These payroll taxes are put into two Social Security Trust Funds, which also earn interest. According to projections by the Social Security Administration, the trust funds will continue to show net growth until 2022, after which, without increases in the payroll tax or cuts in benefits, fund assets are projected to decrease each year until they are fully depleted in 2033. At that time, it's estimated that payroll taxes would only be able to cover approximately 75% of program obligations.

Medicare. Created in 1965, Medicare is a national health insurance program available to all Americans age 65 and older, regardless of income or medical history. It consists of Part A (hospital care) and Part B (outpatient care)--which together make up "traditional" Medicare; Part C (Medicare Advantage, which is private insurance partly paid by the government); and Part D (outpatient prescription drugs through private plans only). Medicare Part A is primarily funded by a 2.9% Medicare payroll tax (1.45% each from employee and employer), which in 2013 is increased by 0.9% for employees with incomes above \$200,000 (single filers) or \$250,000 (married filing jointly). In addition, starting in 2013, a new 3.8% Medicare contribution tax on the net investment income of high-earning taxpayers will take effect.

Looking ahead, Medicare and Medicaid are expected to face the most serious financial challenges, due primarily to increasing enrollment. The Congressional Budget Office, in its report *Budget and Economic Outlook: Fiscal Years 2012 to 2022*, predicts that federal spending on Medicare will exceed \$1 trillion by 2022, while federal spending on Medicaid will reach \$605 billion (state spending for Medicaid is also expected to increase). According to the CBO, reining in the costs of Medicare and Medicaid over the coming years will be the central long-term challenge in setting federal fiscal policy.

Reform

There has been little national consensus by policymakers on how to deal with rising entitlement costs. At some point, though, reform is inevitable. That's why it's a good idea to make sure your financial plan offers enough flexibility to accommodate an uncertain future.



In these challenging economic time, you may be considering taking a withdrawal from your traditional IRA. While you're allowed to withdraw funds from your IRAs at any time, for any reason, the question is, should you?



Technically, there are three IRS-approved methods for calculating SEPPs--the RMD (required minimum distribution) method, the fixed amortization method, and the fixed annuitization method. The rules for calculating your SEPPs can be found in IRS Notice 89-25 and Revenue Ruling 2002-62.

The "SEPP" Exception to the IRA Premature Distribution Tax

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Why you should think twice

Taxable distributions you receive from your IRA before age 59½ are generally referred to as premature distributions, or early withdrawals. To discourage early withdrawals, they're subject to a 10% federal penalty tax (and possibly a state penalty tax) *in addition to* any federal and state income taxes. This 10% penalty tax is commonly referred to as the premature distribution tax.

However, not all distributions before age 59½ are subject to the federal penalty tax. For example, the penalty tax doesn't apply if you have a qualifying disability, or if you use the money to pay certain medical, college, or first-time homebuyer expenses.

The SEPP exception to the penalty tax

But one of the most important (and often overlooked) exceptions, from a retirement income perspective, involves taking a series of "substantially equal periodic payments" (SEPPs) from your IRA. This exception from the federal penalty tax is important because it's available to anyone, regardless of age, and the funds can be used for any purpose.

SEPPs are amounts that are calculated to exhaust the funds in your IRA over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods, and take at least one distribution annually.

Calculating your payment

If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. It's up to you. But you can't use only a portion of an IRA to calculate your SEPPs.

You can also use tax-free trustee-to-trustee transfers (or rollovers) to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas. This makes the

SEPP exception a very important and flexible retirement income planning tool.

Modifying your payments

Even though your payments must be calculated as though they'll be paid over your lifetime (or over you and your beneficiary's lifetimes), you don't actually have to take distributions for that long. You can change, or stop, your SEPPs after payments from your IRA have been made for at least five years, or after you reach age 59½, whichever is later.

But be careful--if you "modify" the payments before the required waiting period ends, the IRS will apply the 10% penalty tax (plus interest) to all taxable payments you received before age 59½ (unless the modification was due to your death or disability).

For example, assume Mary began taking SEPPs from her traditional IRA account three years ago, when she was 43 years old (using one of the three IRS-approved methods). Mary does not take a distribution this year. Because Mary's payment stream has been modified before she turned 59½, the 10% penalty (plus interest) will now apply retroactively to the taxable portion of all her previous distributions.

The five-year period begins on the date of your first withdrawal, so you can't make any changes before the fifth anniversary of that withdrawal. This is true even if you turn age 59½ in the meantime.

For example, assume John began taking SEPPs from his traditional IRA (using an IRS-approved method) on December 1, 2009, and that he also took payments on December 1 of 2010, 2011, and 2012. John turned 59½ on December 2, 2012. Even though John is over age 59½, he must take one more payment by December 1, 2013. Otherwise, he'll be subject to the 10% penalty on the taxable portion of the distributions he took before he turned age 59½.

Caution: *To ensure that your distributions will qualify for the SEPP exception to the premature distribution tax, be sure to get professional advice. The calculation of SEPPs can be complicated, and the tax penalties involved in the event of an error can be significant.*

Also, if your state imposes a penalty tax on early withdrawals, be sure to determine whether any similar exemption from the state tax is available to you.

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I refinanced my mortgage loan last year. Can I deduct any of the costs associated with refinancing the loan?

Now more than ever, homeowners are taking advantage of historically low interest rates and refinancing their mortgage loans. Did you pay points to your lender when you refinanced your loan? If so, you may be able to deduct them.

Points are costs that a lender charges when you take out a mortgage loan or refinance an existing mortgage loan on your home. One point equals 1% of the loan amount borrowed (e.g., 2 points on a \$300,000 loan equals \$6,000).

In order for points to be deductible, they must have been charged by your lender as up-front interest in return for a lower interest rate on your loan. If the points were charged for services provided by the lender in preparing or processing the loan, then the points are not deductible.

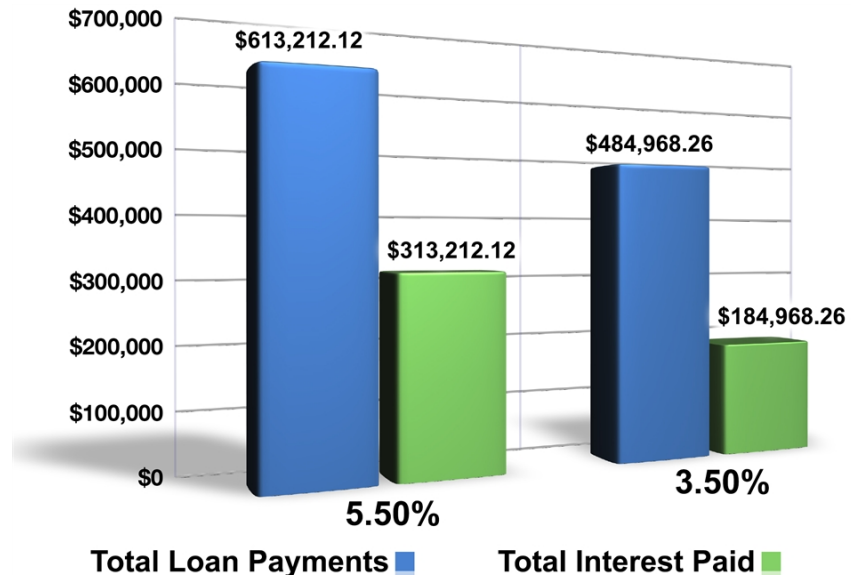
When deducting points, keep in mind that unlike points paid on a loan used to purchase a home, points paid on a refinanced loan usually cannot be deducted in the year that you paid them. Instead, the points may need to be amortized over the life of the loan.

For example, assume that you refinanced to a \$300,000/30-year mortgage loan and paid \$6,000 in points. You would be able to deduct 1/30 of those points each year over the 30-year loan period, or \$200 per year.

The one exception to the amortization rule is if part of your refinanced loan is used to make improvements to your primary residence. In that case, you may be able to deduct the portion of the points that is allocable to the home improvements in the year that the points are paid. In addition, if you choose to refinance again or sell your home in the future, you can generally claim the entire unamortized deduction that remains. For more information on the deductibility of points, you can refer to [IRS Publication 936](#).

As for other costs you may have incurred from refinancing, such as recording, title search, appraisal, and attorney's fees, they are not deductible. Furthermore, unlike costs associated with a home purchase, costs associated with a refinance cannot be added into the cost basis (value) of your home for income tax purposes.

The Potential Benefits of Refinancing Your Mortgage



Assuming a \$300,000/30-year fixed-rate mortgage

This is a hypothetical example and does not reflect all of the costs that may be associated with refinancing. Actual results may vary.