TAX NEWS LETTER 2012

By Stephen B Smith CPA

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For the most part, tax laws, deductions and rates are essentially the same or identical for 2012 as they were in 2011.

Instead of reviewing what few changes are taking place for 2012, I thought I would focus on expected changes for 2013 with comments on how it may affect you.

As many of you know, congress and the president have agreed on certain tax considerations (the revenue side of the budget) but not the spending side which will be debated in the weeks to come. In general for most taxpayers, tax laws and rates will remain the same for 2013 as 2012 except for certain high income individuals.

A summary of the more important law changes under the **"American Taxpayer Relief Act of 2012"**:

- Employee wage Social security tax rate withholding rate will increase from the current 4.2% to the old 6.2%. As a result, employees can expect to see an immediate decline in their paycheck.

- Tax rates will stay the same for taxable income less than $450,000 for joint earners and $400,000 for those filing as single individuals. The tax rate on these amounts has increased from 35% to 40%.

- Capital gain tax rate for individuals earning more than $400,000 is increased to 20%

- Dividend income for taxpayers earning $400,000 of taxable income (single filers and $450,000 joint) will continue to be taxed at the lowest rate for capital gain income.

2012 tax law extenders through 2013:

- $250 per person deduction for teachers of elementary and secondary schools paid out of pocket qualified expenses.
- Tax credit for residential energy home efficiency improvements
- Exclusion from taxable income amounts attributable to discharge of qualified mortgage indebtedness.
- Qualified mortgage premium insurance itemized deduction
- Deduction of either state income tax or sales tax as an itemized deduction
- Charitable donation deduction for real estate property used for conservation easements
- Tuition deduction or tax credits on higher education payments allowed

2012 tax extenders and made permanent through 2018:

- "American Opportunity" tax credit – Extends tax credit for college student tuition and fees paid to a qualifying institution.

- Alternative minimum tax ("AMT") – Exemption deduction increased permanently so as to exclude low income taxpayers. Most taxpayers were never aware of the AMT tax although it has been in the news media on various occasions. In general, without the exemption increase, most taxpayers, low income and wealth would pay more tax. Now this tax is mostly applied to high income earners.

- Increase earned income credit for low income earners

Steve's Tax Corner:

Topic 1 – When can I retire?

To retire or not to retire, that is truly the question! For many, this issue is farthest from their mind while for others, answer to this question if currently relevant. The truth is that we **ALL** need to be concerned with and plan for our retirement; twenty year olds to age 65 make no difference.

I hear this question a lot. The reality is that we are all different and the issues complex. Some are married, some single, some with children, some ready to retire and some forced into retirement whether they like it or not. Then again, the same financial issues apply to all.

To adequately discuss this, a few "ground rules" are needed:

- **Social security benefits** are truly "supplemental". Benefits can be received starting on your full retirement age. For current retires that is age 65. For others it will be age 66 or later depending on your date of birth. Visit www.SSS.gov. I you retire earlier, your benefit will be reduced with reductions if you work more than allowed. Realistically, social security benefits provide less than 50% of the retiree's needs.

- **Medicare benefits** starting at age 65 provides most medical care benefits but not all.

- **10% IRS penalty** exists for pension distributions received by persons aged less than 59 ½. Exceptions exist for college, medical, new home purchase, age 55 annuities and other.

- **Tax effect** – most pension plans are "pre-tax" (plans including: Traditional IRA, 401K, 403b). What that means is that when monies were contributed to the plan a tax deduction was taken or some other type of exclusion ("compensation deferral"). Therefore, when the amounts are withdrawn, distributions received are fully taxable.

- **"Present-value (PV)" computations** – Here is the "biggie". The "present value" calculates the amount you will need "today" (the date you retire) which will provide for a specific periodic payment requirement living expenses. To calculate the "PV" you need three out of the four following items: monthly payment needed estimated interest rate, term of the payments (in years) or current value.

Ok, what does this mean? Ok, in layman's terms! If you can determine your monthly retirement cash flow needs, estimate a rate of return (interest rate) and your life expectancy, you can use the PV to calculate the amount needed to retire.

- **Health and legacy issues** - Sorry, but you're expected health issues and life expectancy are very important. Legacy issues are also important. Do you want to leave something "behind" for children, grandchildren or others? Right now the average life expectancy is 85 - 95. Live longer, great! Shorter, not so!

- **Remember** – retirement means the "golden years". Therefore, you will need to plan for retirement activities and the cash needed to accomplish them: hobbies, travel

How do I calculate my retirement cash needs:

- **First budget** – The most important item of all is to prepare a realistic budget.
  - Prepare a current year budget of income and expense as it now exists. Include all items of income and expenses categorized. Use of software such as Quicken and Quick Books can help. I use excel spreadsheets.
  - **Prepare the budget on an "annual basis".** Preparation on a year basis is very important.
  - Now – remove any items that will be eliminated in retirement re: mortgage payments, home improvements, children issues etc.
  - Include reserves for unexpected income and expenditures. These amounts would be added to savings routinely.
  - Include "fun" items like travel and activities that require $$$$.
  - Take the total and divide by 12 months. Round up and this is the monthly estimated retirement payments needed
- **Secondly**, review your health issues to determine when to retire and how long you may live.
- **Thirdly,** review your current sources of retirement already saved.
- **Lastly,** calculate the PV:
  - The following are three examples based on the following assumptions:

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	Example 1	Example 2	Example 3
Yearly total expense budget	$35,000	$40,000	$45,000
Monthly expense (divided by 12)	2,917	3,333	3,750
Social security monthly provided *	(1,667)	(1,667)	(1,667)
Monthly pension required – pre-tax:	1,250	1,666	2,083
Tax rate effect applied **, ***	80%	80%	80%
Monthly pension required – after tax	$ 1,563	$ 2,083	$ 2,604
Present value ("PV") – amount needed to retire, at 3%**** for 20 yrs	$ 282,531	$ 376,527	$ 470,703

For a yearly budget of $30,000, the amount saved must be $188,218
For a yearly budget of $25,000, the amount saved must be $94,071

What this means is that if you were to retire at age 66 and hope to live to age 86, needing $1,563 in "after-tax dollars" plus $ 1,667 in social security benefits to pay for a $35,000 annual budget, you would need to have a combined (non-social security) pension value of $282,531. If you needed $40,000 in annual expenses, your pension would require $376,527 on date of retirement and $470,703 for $45,000 in annual expenditures.

Obviously, the amounts are significant.

If you would like to retire but have no (non-social security) "nest egg", the advice is to keep working.

Finally, the longer you work, the closer you get to your life expectancy the less you need. Therefore a review of all factors must be made periodically.

* Assumes a $20,000 total benefit or $ 1,667 per month mostly non-taxable.

** Assumes all of the pension balances are pre-tax. If any amounts are in "ROTH IRA" accounts which are non-taxable, no tax rate would be applied.

*** Assumes 15% federal and 5% Maine state tax.

**** If the amount saved earns less than 3% a year, the amount to retire increases by a factor of 1.2X the amount stated based on a 1.5% return rate.

Sincerely,
Stephen B. Smith, CPA