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The Long-Term Fiscal Status Of The United States

The good news is the fiscal outlook of the United States government is suddenly much brighter. The bad news is things are so much better than just a couple of years ago that Congress might squander the opportunity because lawmakers no longer feel great urgency to address the long-term fiscal problems threatening the country.

The Congressional Budget Office, the non-partisan research arm of Congress, released a 10-year projection on February 24, 2014 of the U.S. Government's spending and revenue, showing that the federal budget deficit increases only slightly over the next 10 years. This is an amazing turnaround.

In 2012, the fiscal condition of Greece, Italy, Portugal and Spain sent investors worldwide scrambling in search of safe havens because they feared the poorer countries of the EU would be unable to pay their debts. At that time, some members of Congress publicly voiced fears that the U.S. was headed for the same fate as the poorer nations of southern Europe, which sent the U.S. stock market into a temporary tailspin. But the U.S. economy has proven resilient.

Aggregate government spending as a percent of gross domestic product does not appreciably increase over the next decade, according to the latest CBO estimate. In comparison, in the depths of the financial crisis in 2009, according to the CBO, the U.S. Government deficit was equal to 9.8% of the total U.S. economy. That was when fears that the U.S. was headed the same direction as Greece and Portugal hit its peak.

Then the economy turned around. Sequestration forced a 10% across the board cut to U.S. Government spending in 2013. Congress passed a new tax law that hiked income tax rates and raised new government revenue. According to CBO, the U.S. Government is on course to hit just 2.6% deficit as a percent of GDP in 2015, nearly a quarter of the ratio just a few years earlier.

While on its face this is very good news, it could make it more difficult for Congress to find the political will to address the longer-term issues threatening the long-term financial stability of the U.S. The long term financial picture of the U.S. – projections made by CBO in an annual report issued in December 2013, provided a 50-year projection of the U.S. fiscal position that shows that the long-term solvency of the U.S. remains under great pressure and deteriorates rapidly after 2024.

According to data from CBO, spending by the federal government as a percent of GDP on Medicare, Medicaid, and Social Security remains stable over the decade ending 2024. However, spending on these programs increases starting in 2024, CBO's report shows. In addition, the biggest expense that goes along with all this government spending is the interest expense. To be clear, all of the government spending is paid for with borrowed money that is raised from the proceeds of U.S. Treasury

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Happiness

It has been said that happiness is a feeling of contentment and peace of mind. Life isn't always happy, but is a mixed bag of joy and sadness, laughter and tears, pain and growth. Happy people accept the whole package, realizing that happiness is only a part of life's puzzle.

Over the past couple months I've had several experiences pop up concerning happiness...

Jane Davis, a wonderful client in her 80's recently shared 3 things for a happy life. First, have someone or something to love. Second, have something to do. Third, have something to look forward to. Great words to live by!

While attending a dental retreat, one of the presenters, Dr. Tim Leary, made this profound statement: "If you want to be happy for an hour, take a nap. If want to be happy for a day go fishing. If you want to be happy for a week, take a vacation. If for a month get married. For a year, inherit a fortune. But if you want happiness all your life it only comes by helping others."

The deepest happiness you can have comes from that capacity to help relieve the suffering of others. Nothing compels us, except the joy of sharing peace, the joy of sharing freedom from afflictions, freedom from worries, freedom from cravings, which are the true foundations for happiness.

Ron Howard, Mike Demko, Mike Weakley, Chris Cox and Diem Pham

Count On The Portability Provision

Though it's still true that you can't take it with you, a recent tax law change makes it easier to reduce or eliminate estate tax liability for your heirs. Thanks to a "portability" provision that's now part of the law, any unused portion of the individual exemption from federal estate tax that isn't used by the estate of the first spouse to die may be claimed by the surviving spouse's estate.

This special estate tax break, first enacted in 2010, was set to expire after 2012. However, the American Taxpayer Relief Act (ATRA) extended it for 2013 and thereafter. Barring drastic change, you can count on portability for the foreseeable future.

Under ATRA, the federal estate tax exemption is locked in at a generous $5 million that is increased annually to account for inflation. (The exemption for 2014 is $5.34 million.) As a result, a couple in 2014 can transfer up to $10.68 million without incurring a dime of federal estate tax.

Suppose a husband owns $4 million on his own, his wife has $3.5 million, and they hold $2.5 million in both their names—jointly with rights of survivorship, in legal jargon. Each spouse's will leaves his or her entire estate to the other spouse and, upon the death of that spouse, to the couple's children.

Now suppose that the husband dies first in 2014. Because all of his individually owned assets pass to his wife, his estate needn't use any part of his federal estate tax exemption. (Spouses normally can inherit an unlimited amount from each other without estate taxes.) So the wife now owns all of the couple's assets, worth a total of $10 million. When she dies, that $10 million in assets goes to the couple's children. Without portability, the wife would have only her own exemption, and that would leave her estate responsible for estate taxes on $4.66 million (the $10 million in assets minus her $5.34 million exemption). At the current 40% estate tax rate, the estate would owe more than $1.8 million—money that wouldn't go to the children. With portability, however, the combined exemption of $10.68 million more than covers the $10 million in the estate, and the heirs pay no estate tax.

As beneficial as the portability provision can be, it won't necessarily solve every potential estate-planning problem. For example, it still might be a good idea to establish a bypass trust, a tool that, before portability, could be used to maximize the estate tax exemptions of married couples. Although no longer needed for that purpose, a bypass trust still could be used to protect assets from creditors, guard against other tax consequences, such as the generation-skipping tax, and be especially helpful in allocating assets when one or more spouse has children from a previous marriage. ●

Markets May Not Be Certain, But Experience Is

Have you ever wished you could do it all over again? Experience can be a great teacher, and it's natural to imagine that with the benefit of hindsight you would have made better decisions about everything from raising your children to managing your financial affairs. And while that may or may not be true, what is certain is that you can offer younger family members some of the insight you've acquired along the way.

Here are some thoughts you might pass along:

1. When you get a pay raise or a new higher-paying job, consider earmarking at least part of the additional money for retirement savings. You'll be amazed by what tax-deferred compounding can do to even relatively small sums over the course of several decades. And using raises to increase your contribution to a 401(k) can be relatively painless. Ratchet up your saving rate by a percentage point or two each year and you'll soon reach the maximum for annual pre-tax contributions to 401(k)s and similar employer-sponsored plans—$17,500 in 2014 if you're younger than age 50. Beginning at 50, you'll be eligible to contribute an extra $5,500 a year.

2. Try to resist the siren song of early retirement. Leaving your job in your 50s may be tempting, but it runs counter to several financial realities. Most people have not saved enough to retire comfortably even at the traditional age of 65, and quitting early can mortgage your future in two ways—reducing the amount you can save while extending the time that your savings must support you. By the same token, however, every year you keep working improves your situation. Moreover, as life expectancies increase, more and more people find they want to stay on the job at least part-time, and not only for financial reasons. Working can help keep you engaged and healthy,

Entering The Twilight Zone—Of Taxation

Rod Serling, creator of the classic science-fiction TV series, “The Twilight Zone,” could not have come up with a stranger tax structure. You have entered a five-dimensional tax zone, a tax labyrinth so strange it almost seems like science fiction.

There’s more to the federal income tax system than just a single calculation. In fact, upper-income taxpayers—especially those generating income from investments—actually must cope with five “dimensions” of taxation: (1) ordinary income tax; (2) capital gains and losses; (3) the alternative minimum tax; (4) the net investment income tax; and (5) a reduction of itemized deductions and personal exemptions. Here’s a quick rundown:

1. Ordinary income tax. This is the standard tax calculation we’re all familiar with. The income you earn generally is taxed under a graduated rate structure with seven tax brackets: 10%; 15%; 25%; 28%; 33%; 35%; and 39.6%. If you’re in the top tax bracket, any extra income you earn is taxed at the 39.6% rate. Tax deductions and credits can be used to offset your tax liability based on these ordinary income rates, but certain special rules may apply (see #5).

Furthermore, under the “kiddie tax,” if investment income of a dependent child exceeds an annual threshold ($2,000 in 2014), the excess generally is taxed at the top tax rate of the parents. This can hike the overall family tax bill.

2. Capital gains and losses. The tax law provides separate tax treatment for capital assets such as securities and real estate. Generally, gains and losses from capital assets are used to offset each other. Long-term gains from assets held longer than a year qualify for a maximum 15% tax rate, but the rate increases to 20% for those in the top two ordinary income tax brackets. Qualified dividends also benefit from these preferential tax rates.

In addition, you can use excess capital losses to offset up to $3,000 of ordinary income, and you can carry additional losses over to next year. With that in mind, “harvesting” losses is a common year-end tax strategy.

3. Alternative minimum tax. The alternative minimum tax (AMT) runs on a track parallel to ordinary income tax. This complex calculation involves certain additions and adjustments before subtracting an exemption amount based on your tax filing status. However, the exemption is reduced for high-income earners. There are just two tax brackets—26% and 28%—for taxpayers with AMT liability.

At tax return time, you compare your ordinary income tax result to the AMT result and effectively pay the higher of the two. This “alternative” tax often catches unwary taxpayers by surprise.

4. Net investment income tax. The “net investment income” (NII) tax is a new wrinkle that taxpayers have to deal with for the 2013 tax year and beyond. You must pay a 3.8% Medicare surtax on the lesser of your NII or your modified adjusted gross income (MAGI) above an annual threshold—$200,000 for single filers and $250,000 for joint filers. For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. But some items, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from IRA and qualified retirement plans, are excluded from the definition.

The NII tax is an add-on to the ordinary income tax calculation. Thus, your combined top tax rate can be as high as 43.4%!

5. Reduction of itemized deductions and personal exemptions. Two tax law provisions that were reinstated in 2013 may affect upper-income taxpayers adversely. Under the “Pease rule” (named for the congressman who originated it), certain itemized deductions, including those for charitable donations, state income tax, and mortgage interest, are reduced if your adjusted gross income (AGI) exceeds an annual threshold. For 2014, the threshold is $254,200 of AGI for single filers and $305,050 for joint filers. The total of your itemized deductions covered by the Pease rule is reduced by 3% of the amount above the AGI threshold, but not by more than 80% overall.

A similar rule phases out the tax benefit of personal exemptions. Under the personal exemption phaseout (PEP) rule, exemptions are reduced by 2% for each $2,500 (or portion thereof) of your AGI that exceeds an annual threshold. The PEP thresholds are the same as those for the Pease rule.

Beyond these five, a sixth dimension exists for most taxpayers—state income taxes. ●

particularly if you find something you really like to do.

3. Consider postponing Social Security. You can begin receiving benefits as early as age 62, but each year you delay will increase the amount of your monthly payment, and if you wait until age 70, you’ll get 76% more than if you had started drawing benefits at 62. And most people will live long enough to get a larger total payout if they begin later.

4. Don’t feel like you have to go it alone in making financial decisions. Working with an advisor could help you make sense of complex financial markets and chart a comfortable path toward your goals. The right advisor can assist you in deciding how much to save, how to allocate your investments, how to weigh the pros and cons of buying a home and other major financial choices, and, when the time comes, how to deploy your retirement nest egg. ●

Is It Too Late For Roth Conversion?

When you're creating a retirement paycheck from a blend of Social Security, pensions, and personal retirement accounts, it only makes sense to do what you can to minimize income and investment taxes. For example, consider the distributions from your traditional IRAs or 401(k)s. Most or all of that income will be taxed at full income rates that now go as high as 39.6%. In contrast, under most circumstances, withdrawals from Roth IRAs aren't taxed at all. So should you switch from traditional IRAs to a Roth? Or is it too late to benefit from such a conversion?

The answer depends on your situation. Because you'll have to pay income tax on the money you convert to a Roth IRA, one crucial calculation involves whether your federal income tax bracket will be higher or lower during retirement. It usually makes sense to convert before retirement if you expect to be in a higher tax bracket later, while if you anticipate being in a lower bracket in retirement, you probably should wait until then to convert. If you are retired and expect to remain in a relatively low tax bracket, you might decide not to convert at all.

The main attraction of a Roth IRA for retirees is the lure of tax-free payouts while living on a fixed income. Distributions you take after age 59½ from a Roth you've had for at least five years will be exempt from federal income tax. And, from an estate planning view, with a Roth you won't be subject to the mandatory lifetime distributions that traditional IRAs require. But because a Roth conversion is taxable, it's like taking money out of an IRA for almost any other reason—and it may or may not pay off.

Example 1: You're in the 39.6% tax bracket now, you expect to be in the 28% bracket in retirement, and you have $500,000 in an IRA. If you convert to a Roth this year, you'll have to pay a tax of $198,000. That's probably not worth the future benefit of receiving tax-free payouts—money that would have been taxed at the 28% rate without the conversion. However, if you wait until you drop into the 28% bracket, the conversion will cost less and may be worthwhile.

Example 2: You're in the 28% bracket now, you expect to be in the 39.6% bracket during retirement, and you have $100,000 in an IRA. If you convert to a Roth this year, you'll pay a tax of at least $28,000. (It may be higher because part of the conversion could be taxed at a 33% rate.) But that may be preferable to being taxed on that money at the top 39.6% rate during retirement.

You'll also need to weigh other factors, including the size of your account and whether a series of smaller conversions might reduce your overall tax liability. Also, a Roth conversion effectively could increase the 3.8% surtax on your net investment income. We can help you figure out the best strategy for your situation. ●

Long-Term Fiscal Status

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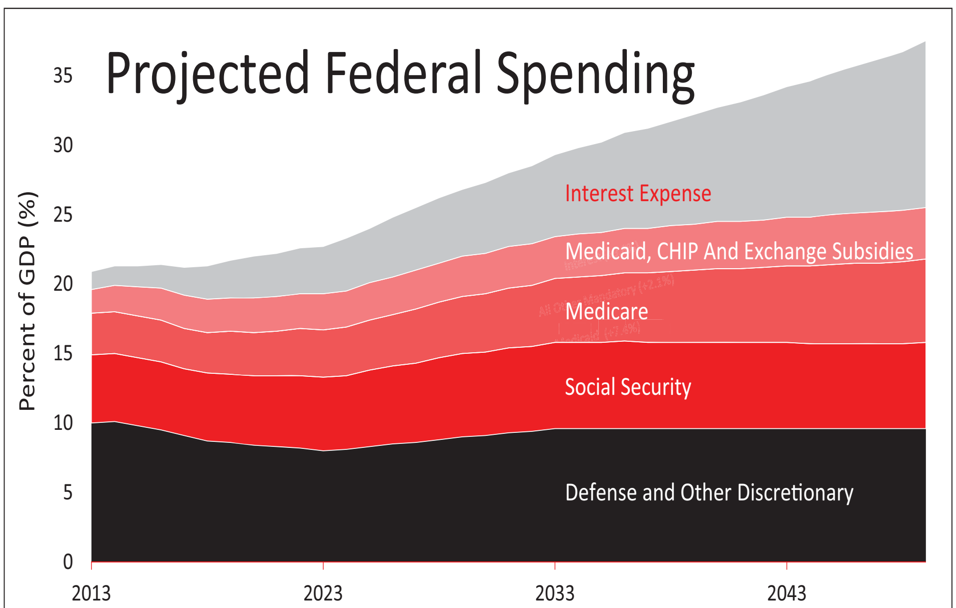
Bond sales. Interest expense on the Government debt to pay for Social Security, Medicare and Medicaid skyrockets over the next 50-years.

So here's the problem: Unless the U.S. Government does something to reduce government entitlement programs, the U.S. is headed for fiscal oblivion. But the nearer-term picture – the outlook over the decade ending in 2024 — is good. The fiscal condition of the U.S. looks strong for the next decade, which could be bad news if it means Congress can "kick the can" further down the road and delay addressing the real problem threatening the U.S. Government's fiscal stability ●



Source: Congressional Budget Office (CBO), *The 2013 Long-Term Budget Outlook*, September 17, 2013.