This message contains information regarding tax-law changes, 401k conversions, end of year reminders, and PWA-specific announcements. While no action is necessary from you in response to this message, we highly recommend that you read it in full prior to the end of 2010

Clients –

As the end of the year approaches, I wanted to send out a few quick updates and reminders on a number of different topics:

1) The bill to keep tax rates and most income tax law at the status quo for two more years has made it through Congress and we're confident that it will become law before the end of the year. The bill includes the following:
    a. Two year extensions for all six current Federal income tax rates and brackets
    b. Caps on itemized deductions and personal exemptions based on income levels are put off until 2013
    c. Long-term capital gains and dividend tax rates are extended at current levels through 2012 for all taxpayers (15% for the top 4 tax brackets, 0% for the bottom 2).
    d. A patch for the Alternative Minimum Tax (AMT) like has been passed for the last few years to increase the exemption amount and reduce the number of taxpayers impacted by AMT.
    e. Extensions of credits like the Child Tax Credit and the American Opportunity college credit.
    f. The ability for taxpayers to choose to deduct income tax or sales tax paid, a key deduction those living in states without state income taxes.

   This is good news for all of you in that you'll pay less tax next year than you would have if the bill didn't pass and your overall financial plan won't be impacted, at least in the short-term. Of course the national deficit and debt continue to balloon, so it would be prudent to begin to expect that at least individuals in the top two tax brackets will see rising tax rates in the future. We will begin to plan for this increase for impacted clients.

2) The bill also includes a couple of sweeteners as a proposed economic stimulus:
    a. A 2% cut in the payroll (social security) tax rate from 6.2% to 4.2% for 2011 only. For those making $100k per year, this amounts to a temporary $2k "raise" next year and will be distributed through reduced withholding.
    b. Immediate expensing of 100% of assets placed in service by businesses for 2011 and 50% expensing in 2012 instead of having to depreciate the value of those items over their useful life.

3) Included in the same bill are some major changes in estate taxes. In 2010, the estate tax was repealed, with its reinstatement set for 2011 with only a $1M per person exemption and a tax rate of 45% on amounts over $1M at the time of death. Since this includes personally owned life insurance as well as the rest of individually owned assets and half of jointly owned assets, a $1M exemption would have impacted a fairly sizeable portion of the population (and many of you). The tax bill changes this in four ways:
    a. It increases the exemption to $5M per person
    b. It makes the exemption portable to a spouse so that effectively a married couple has a $10M exemption and no longer has to worry about making certain the first to die uses

as much of their exemption as possible through complex wills with bypass trusts and other sophisticated estate planning tactics.

c. It lowers the top estate tax rate to 35%
d. It increases the lifetime gift exemption (before having to pay gift tax) to $5M per person. This exemption is in addition to the $13k annual gift tax exclusion and it means that parents can gift a large amount of assets to their children before death, allowing future appreciation of those assets to stay out of their estate.

4) Finally, the same bill extends maximum unemployment benefits by 13 months. Those who are out of work will be able to continue to receive benefits through their state unemployment office at current levels.

5) Proposals are being thrown around by a deficit task force that could completely change the way we think of taxes and deductions if they are ever implemented. These include lowering overall tax rates, but eliminating deductions that we're used to like mortgage interest thereby eliminating the tax incentive to own a home. We have also heard rumblings of potentially taxing loans from life insurance policies which is one of the key selling points to whole and universal life insurance that make them worth the frequently excessive cost to some people. The moral of the story here is that with a deficit as big as the one we have and growing as fast as it is, major changes could be coming down the line. We recommend challenging every assumption and as always trying to keep your financial plan as simple as possible. If you can't afford a house without the mortgage interest deduction, think twice about buying it. If you're buying expensive life insurance in hopes of being able to borrow from it in 20 years tax-free, consider cheaper term insurance instead.

6) Many of you have probably received letters from your employer retirement plan stating that you may be eligible to convert your pre-tax 401k balances to a Roth 401k (if your plan has a Roth 401k). We have contacted those clients who may find that provision useful at this time. This is based on a new tax law that is aimed at helping to pull forward some future tax revenue by having people voluntarily pay tax now at today's rates on retirement money that otherwise wouldn't be taxed until withdrawal. For most people, our opinion is that this is not a good idea for two reasons. First, you can only convert your contributions from the pre-tax 401k after you reach age 59 ½ unless you're ok with paying a 10% penalty on the converted amount. Second, while you may be able to convert employer contributions at any age, you are required to add the value of the converted amount to your income and are taxed on that amount at your top marginal tax rate (i.e. converting $100k means adding $100k to your income and paying tax at whatever rate applies to someone who makes your salary plus $100k per year). What's worse, you have to pay the tax out of pocket, not from the 401k plan. This can be a wise choice for those who are taking some time off or having a low-income year for a variety of reasons. It can also be wise for those who expect their income to rise significantly over the next several years and remain high in retirement. Finally, it can work if you have the necessary liquid assets outside of retirement plans that will allow you to pay the tax comfortably without impacting any of your non-retirement goals. For most people, it's a fairly easy decision not to do the conversion. A very similar concept applies with converting pre-tax IRAs to Roth IRAs and we have added a decision point about both of these options to our client's annual financial review process.

7) The tax laws around healthcare flexible spending accounts will change after 12/31/2010. You will no longer be able to use your flex dollars to purchase over-the-counter drugs. This means that if you have a balance remaining in your flex account at the end of the plan year (3/15 for most people), you will not be able to go on a (insert drug store of your choice) shopping spree to use up those flex dollars and they will be forfeited. Therefore, if you think you'll have trouble spending all your flex dollars before end of year, go stock up on your non-prescription drug needs before end of year

8) Business owners and employees who drive their own car for non-commuting business purposes, remember to jot down your end of year odometer reading and continue to keep a log of your daily business driving for tax purposes.

9) As the new decade begins, we're changing the way we'll be communicating with clients. We're starting a facebook page for PWA as well as a blog and a twitter account and eliminating the PWA quarterly newsletter. In a world that continues to move at a faster and faster pace, we think you'll be better served with short ongoing communications rather than an 8-page full-text newsletter every three months. Look out for a communication in early January on how to "like" us on Facebook, follow us on Twitter, and read our blog posts.

As always, if you have questions or comments regarding the information above or any other topics, please don't hesitate to contact me. Have a happy and safe holiday season.

Thanks,
Tom

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