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On the Precipice: the "Fiscal Cliff"

The phrase "fiscal cliff" has been used to describe the unique combination of financial realities scheduled to take effect in 2013: expiring tax breaks; the imposition of new taxes on high-income individuals; and automatic deficit-reduction spending cuts.

Expiring tax breaks

Lower federal income tax rates, part of the tax landscape for more than ten years, expire at the end of 2012. We'll go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%). The maximum rate that applies to long-term capital gains will generally increase from 15% to 20%. And while the current lower long-term capital gain rates now apply to qualifying dividends, starting in 2013, dividends will be taxed as ordinary income. The temporary 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax, in place for the last two years, also expires at the end of 2012, as do temporary breaks relating to the federal estate and gift tax.

Several other significant breaks go away in 2013 as well. Itemized deductions and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs); the earned income tax credit, the child tax credit, and the American Opportunity (Hope) tax credit all revert to old, lower limits and less generous rules; and individuals will no longer be able to deduct student loan interest after the first 60 months of repayment. Lower alternative minimum tax (AMT) exemption amounts (the AMT-related provisions actually expired at the end of 2011) mean that there will be a dramatic increase in the number of individuals subject to AMT when they file their 2012 federal income tax returns in 2013.

New taxes

Beginning in 2013, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for individuals with wages exceeding $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals. This 3.8% contribution tax applies to some or all of the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

Mandatory spending cuts

The failure of the deficit reduction supercommittee to reach agreement in November 2011 automatically triggered $1.2 trillion in broad-based spending cuts over a multiyear period beginning in 2013 (the official term for this is "automatic sequestration"). The automatic cuts are to be split evenly between defense spending and non-defense spending. Although Social Security, Medicaid, and Medicare benefits are exempt, and cuts to Medicare provider payments cannot be more than 2%, most discretionary programs including education, transportation, and energy programs will be subject to the automatic cuts.

Understanding the "cliff"

Many fear that the combination of tax increases and spending cuts will have severe negative economic consequences. According to a report issued by the nonpartisan Congressional Budget Office *(Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013, May 2012),* taken as a whole, the tax increases and spending reductions will reduce the federal budget deficit by 5.1% of gross domestic product (GDP) between calendar years 2012 and 2013. The Congressional Budget Office projects that under these fiscal conditions, the economy would contract during the first half of 2013 (i.e., we would likely experience a recession).

Ways Grandparents Can Help with College Costs

Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. This rule is helpful considering that annual tuition at some private colleges is now surpassing the $40,000 mark.

College is expensive. For some fortunate students, grandparents are stepping in to help. This trend is expected to accelerate as baby boomer grandparents start gifting what could be trillions of dollars over the next few decades. Helping to finance a grandchild's college education can bring great personal satisfaction and can be a way for grandparents to minimize potential gift and estate taxes. Here are some common strategies.

Outright cash gifts

One way to contribute is to make an outright gift of cash or securities to your grandchild or his or her parent. To minimize any potential gift tax implications, you'll want to keep your gift under the annual federal gift tax exclusion amount--$13,000 for individual gifts or $26,000 for joint gifts made by both grandparents. Otherwise, a larger gift may be subject to federal gift tax and, for a gift made to a grandchild, federal generation-skipping transfer tax, which is a tax on gifts made to a person who is more than one generation below you.

An outright cash gift to your grandchild or your grandchild's parent will be considered an asset for federal financial aid purposes. Under this aid formula, students must contribute 20% of their assets each year toward college costs and parents must contribute 5.6% of their assets.

Pay tuition directly to the college

If you are considering making an outright cash gift, another option is to bypass your grandchild and pay the college directly. Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. This rule is helpful considering that annual tuition at some private colleges is now surpassing the $40,000 mark. Only tuition qualifies for this federal gift tax exemption--room and board, books, and fees aren't eligible.

Aside from the benefit of being able to make larger tax-free gifts, paying tuition directly to the college ensures that your money will be used for education purposes. However, a direct tuition payment might prompt a college to reduce any potential grant award in your grandchild's financial aid package, so make sure to ask the college about the financial aid impact of your gift.

529 college savings plan

A 529 college savings plan is a tax-advantaged savings vehicle that can be a smart way for grandparents to contribute to their grandchild's college education while paring down their own estate. Contributions to your account grow tax deferred and earnings are tax free if the money is used to pay the beneficiary's qualified education expenses (states generally follow this tax treatment as well). Funds can be used at any accredited college in the United States or abroad.

You can open a 529 account yourself and name your grandchild as beneficiary, or you can contribute to an already existing 529 account (e.g., a parent-owned 529 account).

Tip: *Under current federal financial aid rules, grandparent-owned 529 plans are not counted as a parent or student asset (only parent-owned and student-owned 529 plans count as assets), but withdrawals from a grandparent-owned 529 plan are counted as student income, which can affect student aid eligibility in the following year (withdrawals from parent-owned and student-owned 529 plans are not counted as student income).*

If you have a large sum to gift, 529 plans offer a big advantage. Under special rules unique to 529 plans, you can make a lump-sum gift of up to $65,000 ($130,000 for joint gifts) and avoid federal gift tax by making a special election to treat the gift as if it were made in equal installments over a five-year period (provided you don't make any additional gifts to the same grandchild during the five-year period). And if you happen to be the 529 account owner, you retain control over these funds. For example, if you should have unexpected medical costs, you can withdraw part or all of your lump-sum contribution (however, you will owe income tax and a 10% penalty on the earnings portion of the withdrawal). In addition, your lump-sum gift is considered removed from your estate even though you retain control over the funds as account owner (but if you were to die during the five-year period, a prorated portion of the gift would be recaptured by your estate for estate tax purposes).

Of course, you can contribute smaller, regular amounts to your grandchild's 529 account as well. If you have more than one grandchild, you can open an account for each and limit your annual contributions to each account to $13,000 or $26,000 for joint gifts. Come college time, if one grandchild gets a scholarship, you can change the beneficiary of his or her 529 account to another grandchild or you can withdraw an amount equal to the amount of the scholarship, penalty free.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing.*

Retirement Rules of Thumb

Rules of thumb are usually based on a sound financial principle, and can provide a good starting point for assessing your retirement needs.

Because retirement rules of thumb are guidelines designed for the average situation, they'll tend to be "wrong" for a particular retiree as often as they're "right." However, rules of thumb are usually based on a sound financial principle, and can provide a good starting point for assessing your retirement needs. Here are four common retirement rules of thumb.

The percentage of stock in a portfolio should equal 100 minus your age

Financial professionals often advise that if you're saving for retirement, the younger you are, the more money you should put in stocks. Though past performance is no guarantee of future results, over the long term, stocks have historically provided higher returns and capital appreciation than other commonly held securities. As you age, you have less time to recover from downturns in the stock market. Therefore, many professionals suggest that as you approach and enter retirement, you should begin converting more of your volatile growth-oriented investments to fixed-income securities such as bonds.

A simple rule of thumb is to subtract your age from 100. The difference represents the percentage of stocks you should keep in your portfolio. For example, if you followed this rule at age 40, 60% (100 minus 40) of your portfolio would consist of stock. However, this estimate is not a substitute for a comprehensive investment plan, and many experts suggest modifying the result after considering other factors, such as your risk tolerance, financial goals, the fact that bond yields are at historic lows, and the fact that individuals are now living longer and may have fewer safety nets to rely on than in the past.

A "safe" withdrawal rate is 4%

Your retirement income plan depends not only upon your asset allocation and investment choices, but also on how quickly you draw down your personal savings. Basically, you want to withdraw at least enough to provide the current income you need, but not so much that you run out too quickly, leaving nothing for later retirement years. The percentage you withdraw annually from your savings and investments is called your withdrawal rate. The maximum percentage that you can withdraw each year and still reasonably expect not to deplete your savings is referred to as your "sustainable withdrawal rate."

A common rule of thumb is that withdrawal of a dollar amount each year equal to 4% of your savings at retirement (adjusted for inflation) will be a sustainable withdrawal rate. However, this rule of thumb has critics, and there are other strategies and models that are used to calculate sustainable withdrawal rates. For example, some experts suggest withdrawing a lesser or higher fixed percentage each year; some promote a rate based on your investment performance each year; and some recommend a withdrawal rate based on age. Factors to consider include the value of your savings, the amount of income you anticipate needing, your life expectancy, the rate of return you anticipate from your investments, inflation, taxes, and whether you're planning for one or two retired lives.

You need 70% of your preretirement income during retirement

You've probably heard this many times before, and the number may have been 60%, 80%, 90%, or even 100%, depending on who you're talking to. But using a rule of thumb like this one, while easy, really isn't very helpful because it doesn't take into consideration your unique circumstances, expectations, and goals.

Instead of basing an estimate of your annual income needs on a percentage of your current income, focus instead on your actual expenses today and think about whether they'll stay the same, increase, decrease, or even disappear by the time you retire. While some expenses may disappear, like a mortgage or costs for transportation to and from work, new expenses may arise, like yard care services, snow removal, or home maintenance--things that you might currently take care of yourself but may not want to (or be able to) do in the future. Additionally, if travel or hobby activities are going to be part of your retirement, be sure to factor these costs into your retirement expenses. This approach can help you determine a more realistic forecast of how much income you'll need during retirement.

Save 10% of your pay for retirement

While this seems like a perfectly reasonable rule of thumb, again, it's not for everyone. For example, if you've started saving for retirement in your later years, 10% may not provide you with a large enough nest egg for a comfortable retirement, simply because you have fewer years to save.

However, a related rule of thumb, that you should direct your savings first into a 401(k) plan or other plan that provides employer matching contributions, is almost universally true. Employer matching contributions are essentially "free money," even though you'll pay taxes when you ultimately withdraw them from the plan.

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Do I need to file a gift tax return?

If you transfer money or property to anyone during any year without receiving something of at least equal value in return, you may need to file a federal gift tax return (Form 709) by April 15 of the next year. If you live in one of the few states that have a gift tax, you may also need to file a gift tax return with your state.

Some gifts aren't taxable and generally don't require a gift tax return. These exceptions include:

- Gifts to your spouse that qualify for the marital deduction.
- Gifts to charities that qualify for the charitable deduction. (Filing is not required as long as you transfer your entire interest in the property to qualifying charities. However, if you are required to file a return to report gifts to noncharitable beneficiaries, all charitable gifts must be reported.)
- Qualified transfers exclusion amounts paid on behalf of anyone, either directly to an educational institution for tuition or directly to a provider for medical care.
- Annual exclusion gifts totaling $13,000 or less for the year to any one individual. (However, you must file a return to split gifts with your spouse. But, if your spouse is not a U.S. citizen, the annual exclusion is increased to $139,000 in 2012 for gifts to your spouse.)

If your gift isn't exempt from taxation, you'll need to file a gift tax return. But that doesn't mean that you have to pay gift tax. Generally, each taxpayer is allowed to make taxable gifts totaling $5,120,000 (scheduled to drop to $1 million in 2013) over his or her lifetime before paying gift tax. Filing the gift tax return helps the IRS keep a running tab on that $5,120,000 basic exclusion amount (sometimes referred to as an exemption).

If you made a gift of property that's hard to value (e.g., real estate), you may want to report the gift, even if you're not required to do so, in order to establish the gift's taxable value. If you do, the IRS generally has only three years to challenge the gift's value. If you don't report the gift, the IRS can dispute the value of your gift at any time in the future.

What happens to my property if I die without a will?

If you do not have a will, your property will generally pass by state law under the rules for intestate succession. Under intestate succession, the state essentially makes a will for you. The state laws for intestate succession specify how your property will pass, generally in certain proportions to various persons related to you. These laws vary from state to state.

The intestate succession laws generally favor spouses and children first. For example, a typical state law might specify that your property pass one-half or one-third to your surviving spouse, with the remainder passing equally to all your children. If you don't have children, your spouse might take all in many states; in other states, your spouse might have to share the estate with your brothers and sisters or parents.

But not all property passes by will or intestate succession. Whether or not you have a will, some property passes automatically to a joint owner or to a designated beneficiary. For example, you can transfer property such as IRAs, retirement plan benefits, and life insurance by naming a beneficiary. Property that you own jointly with right of survivorship will automatically pass to the surviving owners at your death. Property held in trust will pass to your beneficiaries according to the terms you set out in the trust.

So, only property that does not pass by beneficiary designation, joint ownership, will, or trust passes according to state intestacy laws. You should generally use beneficiary designations, joint ownership, and wills and trusts to control the disposition of your property, so that you, rather than the state, determine who receives the benefit of your property.

Even if it seems like all your property will be transferred by beneficiary designation, joint ownership, or trust, you should generally have a will. You can designate in the will who will receive any property that slips through the cracks.

And, of course, you can do other things in a will as well, such as name the executor of your estate to carry out your wishes as specified in the will or name a guardian for your minor children.