Special Tax Update
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Tax Update:

It's April, and taxes are on the minds of many Americans. We work with clients to help manage the challenges created by their success, and taxes are one of the greatest challenges investors face. As investors seek ways to lighten their tax burden, the government is limiting the tools available to higher earners. For example, in the tax bill passed just over two years ago, there were higher marginal tax rates and little known provisions that reduced the deductions and exemptions high-earners were allowed.[1] These changes along with new taxes in the Affordable Care Act, and higher state taxes in states such as Maryland, added up to shock many people last April. We expect the same this year as recent stock market gains will raise the reported income of many investors.

We are also concerned that government's appetite to raise more revenue has not abated. Whether this is due to the noble effort of helping the less fortunate, or if it is to fund the continued expansion of a government that that has made too many promises can be debated. What will not be a matter of debate is that governments will need increased revenue. With an aging population, and with the lower economic classes having difficulty rising up as they have in the past, it seems likely that government outlays and subsequent revenue collection efforts will continue to grow.

As examples, the White House recently proposed limits to the popular 529 program, and to the amount an individual can accumulate inside their 401(k) or IRA plans. There have also been more conversations on how to mandate the acceleration of withdrawals from IRA's so that the government can, in turn, harvest the taxes which investors have been deferring inside these accounts.

So what is next? Could discussions on eliminating the exemption from gains on the sale of a personal residence heat up again? In the interest of greater perceived "fairness" in the United States, where the wealth gap is indeed widening, this is a tax deduction that appears only to benefit the ownership class. Currently, a married couple may be able to shelter up to $500,000 of gains from the sale of their home ($250,000 for unmarried.) It is becoming increasingly difficult to justify tax incentives like these when so many are struggling. Fortunately for homeowners, there are realtors in every voting district. But my suggestion is that if you are sitting on several hundred thousand dollars of gains in your home, and if you are thinking of selling in a few years, you may want to keep an ear open to what is being discussed in Washington. Once any proposed changes are announced, you might see a lot of 'for sale' signs in your neighborhood.

There are a few remaining tax reduction strategies still available, including:

- Roth IRAs
- Municipal Bonds
- Annuities
- Life Insurance

Roth IRAs are limited to lower earners. Roth provisions within 401(k) plans are becoming increasingly popular; and while there is no income limit on who may be eligible for a Roth 401(k), those contributions do not receive any up-front tax deduction. So this is a difficult tradeoff for someone in the higher tax brackets.

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to the Tax Laws.
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Municipal bonds can pay tax-free interest, but yields are not very exciting. Lower cost annuities are becoming increasingly attractive since investors' money can grow on a tax-deferred basis. These accounts can be actively managed without generating interim capital gains taxes, and any interest and dividends are not taxed until they are withdrawn. Finally, life insurance offers perhaps the best way to accumulate cash on a tax-favored basis. Today's cash value life insurance policies offer a wide variety of investment options and allow an investor to shift between accounts without generating taxable gains. Usually we look at these life insurance policies for individuals age 55 and under, and we feel it is the single best opportunity for high earners to avoid the tax burden. Using life insurance in this manner is not new. What has changed is that we are now using it more because of the increase in investment choices that are available including stock index options with a 'zero percent floor'. This broader investment lineup and the higher tax environment make owning a life insurance policy increasingly attractive on a relative basis. Furthermore, given how life insurance has always been treated in the tax code, we do not believe there will be any changes announced soon.

Every investors' situation is unique, and one size does not fit all when it comes to managing the effect of taxes on the success of your financial plan. Please don't hesitate to contact us to discuss your situation and your concerns.

Potomac Wealth Advisors, LLC

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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Source:

[1] For a review of these details, please see IRS Publication 17 for 2013, where they are described on the "what's new" section on page 1.

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