Citi Personal Wealth Management

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Citi Personal Wealth Management

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Citi Personal Wealth Management

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It's Not Over: Strategies for Still-Looming Tax Hikes

Important provisions of Congress's Bush-era tax cut extension expire at the end of 2012—which may make for a taxing 2013. Here's how to start preparing now, while taxes are on your mind.

Last year's tax law uncertainty is over. Let the new worries begin.

In December 2010, Congress extended the Bush-era tax cuts and restored the estate tax. The problem is that most of the new tax law's provisions expire at the end of 2012, raising the prospect of higher federal tax rates in 2013.

In fact, upper-income Americans are already looking at higher taxes in 2013, thanks to a special Medicare tax increase included in last year's health care law. The 3.8% Medicare tax, which can also ding investment gains, will hit couples with modified adjusted gross income of more than $250,000 and individuals above $200,000.

What to do? Here is a fistful of strategies that you might discuss with your Financial Advisor, tax professional and estate planning attorney.

- **If income tax rates rise, municipal bonds may become more appealing.** For example, a 3% municipal bond has a tax-equivalent yield of some 4.6% at today's top federal rate of 35%. But if the top rate rises to, say, 40%, the tax-equivalent yield would climb to 5%.
- **You might rethink the wisdom of holding dividend-paying stocks in your taxable account.** High-income earners may pay the new Medicare tax on their dividends starting in 2013. In addition, while qualifying dividends are currently taxed at a 15% maximum federal rate, they could once again be taxed as ordinary income if Congress doesn't extend the special tax treatment for qualifying dividends beyond 2012.
- **Without a new tax law, the long-term capital gains rate will rise** from 15% in 2011 and 2012 to 20% in 2013. And even if the 15% rate is extended, high-income families may be hit by the Medicare tax. One implication: If you have appreciated stock in your taxable account that you're contemplating selling, you may want to sell before year-end 2012.

- **Consider converting your traditional IRA to a Roth IRA** so you can pay the conversion tax at today's lower income tax rates. Converting may make sense if you expect to be in the same or a higher tax bracket in retirement—and you have funds outside your IRA to pay the tax bill on the taxable sum converted.
- **Look into increasing retirement account contributions** so you can shelter your ongoing gains from any future tax increases, including the Medicare tax. In 2011, you can contribute as much as $16,500 to a 401(k) plan, or $22,000 if you are age 50 or older. Meanwhile, this year's maximum IRA contribution is $5,000, or $6,000 for those 50 and above.
- **You might revisit your estate plan,** given the risk that the federal estate tax exemption may be lower in 2013 and the estate tax rate higher. For instance, you might investigate the benefits of using life insurance for estate planning purposes, and also consider a regular gifting program to your children and other heirs. Each year, you can give up to $13,000 ($26,000 for couples) to as many people as you wish.

One piece of good news: As you wrestle with the continuing tax uncertainty, you may find there's a little extra money in your paycheck in 2011. For this year only, the employee share of the Social Security payroll tax has been trimmed from 6.2% to 4.2%. If you make $100,000 a year, you could take home an additional $2,000 in 2011.

Tale of the Tape: Checking Your Retirement Progress

A quick measure of your savings against your age can provide the motivation you need to start serious planning.

It's a question that retirement savers often ask themselves: Am I on track—or do I need to play catch-up?

For a thoughtful answer that takes into account your individual situation, you really need to sit down with your Financial Advisor and dig into the numbers. But for a quick check on your progress, take a look at the accompanying chart, which tells you how much retirement savings you might endeavor to have at different ages as a multiple of your income.

For instance, if you earn $100,000 a year, the chart suggests you ought to have a $520,000 nest egg at age 50. (The numbers come from *Your Money Ratios*, a book by Charles Farrell.)

Any chart like this is only as good as its assumptions. To calculate these numbers, it's presumed that your income will grow half a percentage point a year faster than inflation and that your investments earn a real, after-inflation return of 4.5%.

At age 65, if you quit the work force with retirement savings equal to 12 times your preretirement income and you use a 5% withdrawal rate, you would potentially have retirement income equal to 60% of your salary. This is less than the 80% target that is often mentioned. But if you're eligible for Social Security, that may get you pretty close to 80%.

Keep in mind that the numbers are rough guidelines, and you'll need to adjust for your individual circumstances. Let's say you are a diligent saver and hence used to living on a relatively modest portion of your salary or, alternatively, that you're willing to throttle back your lifestyle when you retire. In that case, you may need to amass less than 12 times income.

Your age	Savings as a multiple of your annual income
25	0.1
30	0.6
35	1.4
40	2.4
45	3.7
50	5.2
55	7.1
60	9.4
65	12.0

 Figures are for illustrative purposes only. They are not based on client data.

Is It Time to Buy a Second Home?

Whether you're looking for an investment, vacation getaway or place to retire, depressed property prices aren't the whole story. Get a realty reality check first.

Home prices are still down by about a third in much of the country. Mortgage rates have edged up but still seem reasonable. The supply of foreclosed homes, particularly in some prime vacation spots, remains large. Many lenders are even agreeing to "short sales," in which they accept a purchase price that is less than the outstanding mortgage. According to the National Association of Realtors, there were some 652,000 short sales in 2009 and another 589,000 in 2010.

All this raises the question: Is this a good time to buy a second home as an investment, a vacation getaway or a place to retire?

As you ponder the issue, don't focus just on today's depressed property prices and the chance of a market rebound. In fact, if you plan to use the house yourself, you probably shouldn't even think of it as an investment.

Yes, you might get some price appreciation, but that could take several years, and you may not enjoy great gains. Over the past 40 years, home prices have climbed at an average 5.1% a year, according to Freddie Mac. That's barely ahead of the 4.4% inflation rate for the same period.

Meanwhile, you will likely have to deal with hefty out-of-pocket costs, including maintenance, utilities, property taxes and insurance, as well as any mortgage payments. If you're considering an older home, you may periodically face unexpected costs, including replacing the roof, the furnace and perhaps some appliances.

Of course, you won't have as many unforeseen expenses with a new house, and it will likely have better insulation, new windows and perhaps air conditioning. But you'll probably also pay more for it. And you still can't be sure how much it will appreciate.

If you find a tenant for your second home, you will have rental income to cover some or all of your costs. But what if your tenant doesn't take care of the property—or fails to pay the rent?

Prize for Second Place? Higher Taxes

If you sell your primary residence, you don't have to pay capital gains taxes on up to $500,000 in gains if you are married and up to $250,000 if you're single—provided you have lived in the home for at least two out of the last five years prior to the sale.

Thanks to a recent tax law change, however, things are a little rougher for owners of second homes. Previously, if you moved into a second home and used it as your primary residence for at least two years, you got the same $500,000 or $250,000 exclusion when you sold.

But as a result of a law that took effect in 2009, second homes converted to primary residences no longer get the full exclusion. Instead, under the new law, a portion of the gain will be taxed, depending on the years of nonqualified use—the time the property was a vacation home or rental unit—compared with the number of years it was a primary residence.

For example, say a married couple owned a second home for six years. They rented it for four years and then lived there themselves for two years. Under the old law, if they sold it for a profit of $300,000, they would have been eligible for the full exclusion and wouldn't owe any tax.

But under the new law, four-sixths of the gain, or $200,000, would be taxable, while only two-sixths, or $100,000, would be eligible for the exclusion. If they had hung on to the property and continued to live there, they would gradually have come to owe less and less tax on the profit. For further information, contact a tax advisor.

Even if you're willing to take on the risks and expenses of a second home, make sure you investigate thoroughly. If you have friends or relatives in the area where you are proposing to buy, they can tell you about the pluses and minuses.

You will also want a professional opinion. For that, you should meet with at least one real estate agent who knows the local market, including price trends and any potential problems—like a shopping mall that's about to go up across the street from a house you like. The agent should also give you a list of recent sales from, say, the past six months, so you can make a realistic bid.

7 Retirement To-Dos Before You Call It Quits

Help make sure you're prepared by taking care of these important tasks well in advance of your last day on the job.

In 2011, the first of the baby boomers (the generation born between 1946 and 1964) turn age 65. Yes, this will mean big changes for America. But it will also mean big changes for the retirees involved.

Want to make sure you're prepared for retirement? Here are some steps to take before your last day on the job.

- **Get up to speed on Social Security.** Those born between 1943 and 1954 are eligible for full Social Security retirement benefits at age 66. But you can qualify for an even larger monthly check if you wait till age 70. The upshot: This could be a good time to look at any other income sources you have—pensions, income annuities, 401(k) plans, IRAs, taxable-account savings—to see whether you can afford to delay Social Security a bit longer.
- **If you retire before age 65—and thus before you are eligible for Medicare—look into health insurance to cover the intervening years.** One short-term option: Ask your employer about continuing health insurance under COBRA (the Consolidated Omnibus Budget Reconciliation Act). It's often expensive, but it will keep you covered.
- **Create a realistic budget.** Take a close look at your spending for the past few years. Start with the essentials: food, clothing, utilities, insurance premiums and any debt, including mortgage, car payment and credit card debt. Then look at other expenses: restaurant meals, movies and travel. This will give you a good idea of your spending. You may need to tighten your belt a bit—or you may have more room for maneuver than you thought.
- **Set up a home equity line of credit.** This will give you more flexibility if a financial need comes up. The approval process may also be easier while you have a paycheck coming in. Similarly, if you're thinking of refinancing your mortgage, you may want to handle that while you're still working.
- **Plan for long-term care expenses.** If you don't already have long-term care insurance, now may be a good time to look into it. If you're close to 65, the premiums may seem prohibitive. But you could reduce them by accepting a longer "elimination period," perhaps as much as six to 12 months, before benefits kick in.
- **Try to get elective medical procedures and dental work** done while they're still covered by your employer's health insurance.
- **Look into part-time work or other activities,** such as volunteering, to keep your body and mind active in retirement and to give you a sense of purpose. We spend decades preparing financially for retirement—but we often don't give nearly enough thought to what we'll do with all the free time.

Why One Strategist Isn't Sold on U.S. Stocks

Richard Cookson, Citi Private Bank's Global Chief Investment Officer, opens up about the reasons he prefers bonds to most equities now.

After the financial horror show of 2008 and early 2009, talk of a double-dip recession has died down, and the stock market averages have soared. Happy days are here again? Not so fast, says Richard Cookson, who last year joined Citi Private Bank as its Global Chief Investment Officer.

Cookson brings to the job not only years of experience analyzing the financial markets for major Wall Street firms but also writing skills honed during a decade as a reporter and editor for *The Economist*. As he looks around the world today, here is what he likes—and what he's leery of.

Q: You are currently advising clients to overweight U.S. corporate bonds. But isn't there a risk that interest rates will spike higher as economic growth picks up?

Richard Cookson: Everybody's bearish on bonds. We think they're wrong. We think the risk is we'll get another slowdown in the U.S. economy. In that situation, bond yields are much more likely to fall than to rise.

Q: So does that also explain why you're currently underweighting U.S. stocks?

RC: When people talk about the Japanese stock market bubble of the 1980s and the U.S. stock market bubble of the 1990s, they talk as if the Japanese bubble was much worse. That isn't true. In fact, by some measures, U.S. stocks were insanely expensive in 2000. Since 2000, what you've seen in the U.S. is a revaluation of fixed income and equities. The question is, is there further to go? U.S. stocks are cheaper than they were. But there's probably more of a revaluation to come because U.S. stocks are still expensive.

Q: Some folks are worried about renewed inflation. Yet you're also talking about disinflation in the U.S. and other developed countries.

RC: Although the Federal Reserve and the financial markets have become more optimistic about sustainable growth, we're not at all sure this is the case. The situation in the U.S. is eerily similar to the situation in Japan over the past two decades. Once the Fed stops administering the drugs, it really is an open question whether the economy will continue to recover in any meaningful sense. Household debts are still too high, home prices are falling, and higher gasoline prices are likely to be more of a growth concern than an inflationary one. There really aren't the sorts of conditions that would cause core inflationary pressures to spike. There is still a huge amount of economic slack, unemployment is still very high, and growth in borrowing remains anemic.

Q: So you're more excited about U.S. bonds than U.S. stocks. That isn't the sort of message investors are used to hearing.

RC: I'm not an equity bull. I'm not a typical U.S. strategist. But we're also not universally bearish on stocks. We look at cyclically adjusted price-earnings multiples and assume that they'll revert to their long-run average over the next 10 years. We also plug in earnings and dividend growth and the current dividend yield. We then compare our model's implied stock returns with what we could get with high-quality bonds. There are some markets that are astonishingly cheap on that basis.

Q: Right now, you're most enthusiastic about the Japanese stock market, which dropped sharply after Japan's devastating earthquake and tsunami. What's prompted this enthusiasm?

RC: Japanese shares look hugely oversold to us. We think the reaction is too extreme. Japanese shares are about their cheapest in the past 60 years.

Build a Flexible Emergency Fund

Still-high unemployment hasn't diminished the value of having a generous cash cushion. But you may want to explore alternatives that don't divert funds from your regular budget.

A plump emergency reserve has rarely seemed more important.

With the unemployment rate still hovering around 9%, many Americans are anxious to prepare for a rainy day. In fact, a 2010 survey conducted for Citi by Hart Research Associates found that 26% of Americans say building an emergency fund is their highest financial priority.

One rule of thumb states that, in case you lose your job or get hit with hefty medical bills or home repairs, you should set aside six months of living expenses in more conservative investments. Suppose your family spends $5,000 a month on mortgage, utilities, groceries, insurance and other core expenses. You might keep six times that sum, equal to $30,000, in a savings or money market account.

> A large emergency fund means less money going toward other financial goals—so explore the alternatives.

While it's comforting to have that sort of emergency reserve, there is a downside. Not only does this mean less money going toward your other financial goals, but you're also likely to earn only modest returns, especially given today's tiny savings yields.

One alternative: You might consider holding a smaller emergency reserve—maybe equal to two or three months' living expenses—and then line up other ways to get access to money.

For instance, in an emergency, you could borrow from your 401(k) plan, though that option would disappear if you're in a financial pinch because you just lost your job. Indeed, if you left your job, any 401(k) loan would need to be repaid right away—and failing to do so could trigger taxes and penalties.

You might also set up a line of credit that allows you to borrow against the value of your home or arrange to borrow against your investment portfolio's value. To be sure, such strategies carry significant risks and will trigger borrowing costs, and they aren't right for everyone. Remember, if you can't repay these loans, you may be compelled to sell your home or unload investments. Still, these sorts of credit lines can allow you to focus on your longer-term goals, like building up your retirement nest egg, while still knowing you have access to cash if an emergency strikes.

Don't like the idea of borrowing? Here's another option: If you have funded a Roth IRA with regular annual contributions, you may be able to withdraw your original contributions—but not the account's investment earnings—and avoid all income taxes and tax penalties. What if you converted a traditional IRA to a Roth? You may be able to withdraw the sum converted without paying taxes and penalties, provided it's been five years since the conversion.

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Municipal bonds may be subject to state and local taxes, and you may also be subject to the federal alternative minimum tax (AMT).

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Although a money market fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

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