



# BLAKELY FINANCIAL

FINANCIAL CLARITY, INSIGHT & GUIDANCE

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## Year-End Investment Planning and the Fiscal Cliffhanger

Investment planning at the end of 2012 revisits issues that have complicated the planning process for the last two years--tax cut extensions and spending cuts designed to reduce the U.S. budget deficit. Uncertainty about both and whether they will lead to what's been called a "fiscal cliff" in 2013 is likely to affect year-end investment planning yet again.

Despite the uncertainties--or perhaps because of them--it might be worth starting early to look at various "what-if" scenarios in case you need to make last-minute changes to your portfolio. Even though you may not be sure of exactly what will happen in 2013, here are some factors to keep in mind as you plot your year-end strategy.

### Review timing of your investment sales

As of January 1, tax brackets are scheduled to return to their pre-2001 levels. That means the current six tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) are scheduled to become five (15%, 28%, 31%, 36%, and 39.6%). Also, absent further changes, the maximum tax rate on long-term capital gains, currently at 15%, will increase to 20% (10% for those in the 15% tax bracket); those in the 10% or 15% marginal income tax bracket, who now pay a 0% rate on capital gains, will lose that special rate. Finally, qualified dividends, now taxed at a maximum of 15%, will once again be taxed at ordinary income tax rates.

Another factor for high-income individuals in 2013 is a new 3.8% Medicare contribution tax on some or all of the net investment income of individuals with a modified adjusted gross income over \$200,000 (\$250,000 for married couples filing jointly, and \$125,000 for couples filing separately).

Ordinarily, higher rates in 2013 might suggest taking profits in an investment before those higher rates go into effect. However, the November election could affect the scheduled expiration date of those tax cuts, or even whether they expire at all. As a result, it's especially important this year not to let tax considerations be the sole factor in any investment decision. If you're uncertain about a sale, remember that another way to minimize

capital gains taxes is to harvest investment losses that may offset gains.

### Consider the potential economic impact of 2013

The nonpartisan Congressional Budget Office has warned that the tax increases and the roughly \$109 billion in spending cuts could hamper an already sluggish economic recovery. Also, a 2% reduction in the Social Security portion of the payroll tax is scheduled to expire in January, leaving consumers with less to spend. Though there has already been talk about revisiting the spending cuts and tax cut expirations, you might want to consider how your portfolio might be affected.

Some companies are highly sensitive to economic cycles; others offer products and services that people need regardless of how the economy is doing and generally suffer less from a downturn (though any industry or company can have its own challenges). Also, the spending cuts could disproportionately affect some specific industries, such as defense, and companies that rely heavily on government contracts.

### Interest rates and European instability

Partly because of the Federal Reserve's monetary policy and partly because of the European debt situation, interest rates have been at historic lows in recent months. This has meant higher prices for U.S. Treasury bonds, because bond yields move in the opposite direction from bond prices. However, investors who have relied on Treasuries for income and now want to roll over the proceeds of maturing bonds might be disappointed with available rates, which the Federal Reserve expects to remain low well into 2014. If that's the case for you, you may need to explore supplemental sources of investment income, or reexamine your Treasury holdings to see whether they now represent too much of your portfolio.

Even if you decide to wait and see what happens at year-end, planning for multiple scenarios now could help improve any last-minute decisions.

### October 2012

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# Spousal Lifetime Access Trust (SLAT)



**A spousal lifetime access trust (SLAT) can provide a way for you to make a large gift of property sheltered from gift tax by the applicable exclusion amount, while providing some reassurance that if circumstances change and you need access to the property or its income in the future, discretionary distributions could be made from the SLAT to your spouse. If your spouse has only a discretionary interest, the SLAT may also provide some asset protection against future claims.**

So, you are thinking about making a large gift that is sheltered from gift tax by the applicable exclusion amount. However, you have concerns about losing access to the gifted property or its income; you might not need it now, but what if things change and you do need it later? If you are married, one possible solution might be a spousal lifetime access trust (SLAT).

## What is a SLAT and how does it work?

Think of you and your spouse as a family unit. A SLAT is designed to give away property for transfer tax purposes (and possibly for asset protection), while still retaining the possibility that distributions could be made to your spouse as beneficiary of the SLAT for the benefit of your family unit if the need ever arises.

Of course, if you create a SLAT for your spouse and you and your spouse divorce or your spouse dies before you, you generally lose access to the trust property and its income. However, you can provide in the trust document that any interest that your spouse has in the trust terminates upon divorce. You might even provide in the trust document that, if you remarry, your new spouse becomes the spouse with access to the SLAT.

## Using exemptions and avoiding estate tax

You have a basic exclusion amount (sometimes referred to as an exemption) that can protect up to a total of \$5.12 million (scheduled to drop to \$1 million in 2013) from federal gift tax and estate tax, and a separate \$5.12 million generation-skipping transfer (GST) tax exemption (scheduled to drop to \$1 million as indexed for inflation in 2013). (There may also be state taxes to consider.)

You can use your gift tax exemption to make a gift of property to the SLAT that is sheltered from federal gift tax. In addition, the SLAT is designed so that neither you nor your spouse retains any interest that would cause the SLAT to be includable in either of your gross estates for federal estate tax purposes. If the SLAT will be generation-skipping (i.e., it has beneficiaries who are two or more generations younger than you, such as your grandchildren), you may want to allocate GST tax exemption to the trust to protect it from the GST tax.

A SLAT is generally a variation of a credit shelter bypass trust. It is common for a credit shelter bypass trust created at death to provide the surviving spouse with a right to distributions based on an ascertainable standard of health, education, maintenance, and support (HEMS). However, if your SLAT has a HEMS provision

giving your spouse access to the trust while you are alive, it may cause problems for the SLAT. Such an interest could be treated as the right to discharge your legal obligation to provide support to your spouse, which would cause inclusion of the SLAT in your gross estate for estate tax purposes as an interest retained for your life. But, if your spouse's interest is limited to distributions at the sole discretion of an independent trustee (perhaps with a HEMS provision for your spouse after your death), this problem should not arise.

Your spouse could have a mandatory right to income from the SLAT without causing the SLAT to be included in either of your gross estates. However, any income retained by your spouse until death (i.e., not consumed or given away) would be included in your spouse's gross estate.

## Reciprocal trusts

Can you create a SLAT for your spouse, while your spouse creates a SLAT for you? You can, but if the trusts essentially provide reciprocal benefits, merely switching you and your spouse as the spouse with access, the trust you create for your spouse will generally be included in your gross estate for estate tax purposes, and the trust your spouse creates for you will generally be included in your spouse's gross estate. However, you can avoid this reciprocal trust doctrine by making the two trusts sufficiently different, for example, by providing that one trust also give the spouse with access a limited power to appoint trust assets at death among a group of beneficiaries, while the other trust does not have such a provision.

## Asset protection

If you and your spouse are not trustees, and the only distributions that your spouse can receive are at the sole discretion of the trustee, creditors of you and your spouse generally cannot reach the trust assets. The trustee cannot be compelled to distribute trust assets to your spouse. So, if needed, trust assets can be retained in the trust or the trust can provide that distributions may be made to other beneficiaries, outside the reach of you and your spouse's creditors.

**Caution:** *Your creditors may be able to reach trust assets if you transferred the property in anticipation of claims by your creditors, if you retained insufficient assets, or if the transfers to the trust left you insolvent.*

A SLAT is a complicated legal document and should be drafted by an attorney.

# Four Retirement Planning Mistakes to Avoid



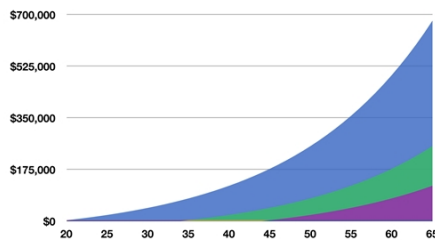
**Because retirement may be many years away, it's easy to put off planning for it. The longer you wait, however, the harder it is to make up the difference later. That's because the sooner you start saving, the more time your investments have to grow.**

We all recognize the importance of planning and saving for retirement, but too many of us fall victim to one or more common mistakes. Here are four easily avoidable mistakes that could prevent you from reaching your retirement goals.

## 1. Putting off planning and saving

Because retirement may be many years away, it's easy to put off planning for it. The longer you wait, however, the harder it is to make up the difference later. That's because the sooner you start saving, the more time your investments have to grow.

The chart below shows how much you could save by age 65 if you contribute \$3,000 annually, starting at ages 20 (\$679,500), 35 (\$254,400), and 45 (\$120,000). As you can see, a few years can make a big difference in how much you'll accumulate.



**Note:** Assumes 6% annual growth, no tax, and reinvestment of all earnings. This is a hypothetical example and is not intended to reflect the actual performance of any investment.

Don't make the mistake of promising yourself that you'll start saving for retirement as soon as you've bought a house or that new car, or after you've fully financed your child's education--it's important that you start saving as much as you can, as soon as you can.

## 2. Underestimating how much retirement income you'll need

One of the biggest retirement planning mistakes you can make is to underestimate the amount you'll need to accumulate by the time you retire. It's often repeated that you'll need 70% to 80% of your preretirement income after you retire. However, depending on your lifestyle and individual circumstances, it's not inconceivable that you may need to replace 100% or more of your preretirement income.

With the future of Social Security uncertain, and fewer and fewer people covered by traditional pension plans these days, your individual savings are more important than ever. Keep in mind that because people are living longer,

healthier lives, your retirement dollars may need to last a long time. The average 65-year-old American can currently expect to live another 19.2 years (Source: National Vital Statistics Report, Volume 60, Number 4, January 2012). However, that's the average--many can expect to live longer, some much longer, lives.

In order to estimate how much you'll need to accumulate, you'll need to estimate the expenses you're likely to incur in retirement. Do you intend to travel? Will your mortgage be paid off? Might you have significant health-care expenses not covered by insurance or Medicare? Try thinking about your current expenses, and how they might change between now and the time you retire.

## 3. Ignoring tax-favored retirement plans

Probably the best way to accumulate funds for retirement is to take advantage of IRAs and employer retirement plans like 401(k)s, 403(b)s, and 457(b)s. The reason these plans are so important is that they combine the power of compounding with the benefit of tax deferred (and in some cases, tax free) growth. For most people, it makes sense to maximize contributions to these plans, whether it's on a pre-tax or after-tax (Roth) basis.

If your employer's plan has matching contributions, make sure you contribute at least enough to get the full company match. It's essentially free money. (Some plans may require that you work a certain number of years before you're vested in (i.e., before you own) employer matching contributions. Check with your plan administrator.)

## 4. Investing too conservatively

When you retire, you'll have to rely on your accumulated assets for income. To ensure a consistent and reliable flow of income for the rest of your lifetime, you must provide some safety for your principal. It's common for individuals approaching retirement to shift a portion of their investment portfolio to more secure income-producing investments, like bonds.

Unfortunately, safety comes at the price of reduced growth potential and the risk of erosion of value due to inflation. Safety at the expense of growth can be a critical mistake for those trying to build an adequate retirement nest egg. On the other hand, if you invest too heavily in growth investments, your risk is heightened. A financial professional can help you strike a reasonable balance between safety and growth.

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## Can I be reimbursed from my health-care FSA for over-the-counter medications?

A health-care flexible spending account (FSA) allows you to pay for certain qualified medical and dental expenses with pretax dollars. With a health-care FSA, you can contribute pretax earnings to the plan (usually through a salary reduction agreement with your employer) and submit qualifying expenses to the plan for reimbursement. If you tend to spend a lot of money on medical expenses that are not covered by your health plan, contributing to an employer-sponsored health-care FSA is a good way to help pay for these expenses.

Although over-the-counter (OTC) medications used to be reimbursable from a health-care FSA, the Patient Protection and Affordable Care Act of 2010 amended the definition of qualified medical expenses for health-care FSA reimbursement purposes. As a result, OTC medications (except for insulin and medications that are prescribed by a physician) are no longer eligible for reimbursement.

However, many OTC medications are also available by prescription. You may want to ask your doctor for a prescription for any OTC

medications that you use on a regular basis (e.g., pain relievers and allergy medications). You'll need to submit the prescription along with a receipt to your FSA provider in order to get reimbursed. Some FSA providers offer forms that allow your doctor to write a prescription once for any of the OTC medications that you'll need throughout the year.

Currently, there is no legal limit on the amount that you can contribute to a health-care FSA. However, most employers do impose a cap on contributions (typically \$3,000 to \$5,000). And beginning in 2013, if a health-care FSA is part of a cafeteria plan, annual contributions will be capped at \$2,500 (starting in 2014, that amount will be adjusted for inflation).

Finally, when participating in an FSA, it's important to remember that you cannot carry over any money you contribute from one plan year to the next--in other words, if you don't use it, you lose it. As a result, it's important to choose your contribution amount carefully so that you don't risk losing any contributions at the end of the plan year.



## Should I participate in my employer's wellness program?

Living a healthier lifestyle can greatly improve one's overall well-being and reduce health-care expenses. As a result, many employers are offering wellness programs to their employees as a way to reduce absenteeism and lower the cost of employer-sponsored health care. According to a 2010 Bureau of Labor Statistics survey, one-third of U.S. private sector workers had access to an employer-sponsored wellness program.

For employers, wellness programs not only reduce health-care costs by promoting healthier living, but they also have been shown to boost employee productivity and morale. The types of wellness programs vary among employers, but they typically cover a variety of healthy living issues, such as:

- Smoking cessation
- Exercise/physical fitness
- Weight loss
- Nutrition education
- Health screenings/assessments

Some companies even provide healthy living education, resources, and incentive tracking through an online "wellness portal."

In addition to helping you live a healthier lifestyle, a wellness program may offer financial benefits. Currently, employers are permitted to offer wellness incentives (e.g., premium discounts, cash rewards) to employees of up to 20% of the cost of their health-care premium. And beginning in 2014, under the 2010 Patient Protection and Affordable Care Act, employers will be able to increase the incentive amount to 30% of the cost of the employee's premium.

Keep in mind that with certain types of wellness incentives, such as cash bonuses or gift certificates, the value of the reward may be treated as taxable wages and therefore may be subject to payroll taxes.