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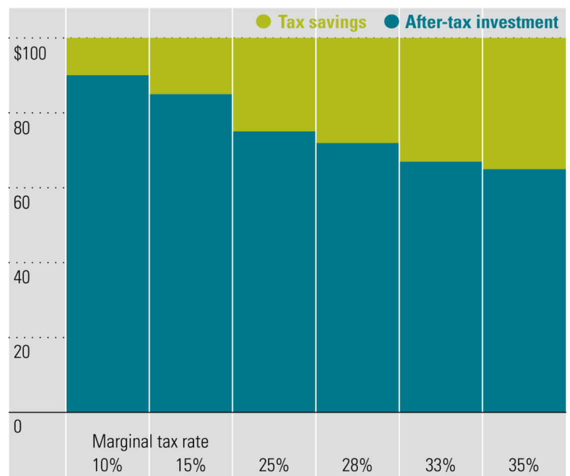
# 401k Contributions and Tax Savings

A commonly-overlooked benefit of 401k investing is that contributions can be made pre-tax, so that even a small contribution can go a long way. In this situation, 401k contributions are not taxed until you retire. Therefore, the more you contribute to your retirement account, the smaller your taxable income becomes, and the more federal taxes you are able to defer.

The image presents the tax savings (reduction in tax liability) achieved by a 401k contribution of $100 for six marginal tax rates. For example, if you are subject to a 35% marginal tax rate and you choose not to contribute, you will pay $35 in taxes and only have $65 available to invest in another account. If, however, you invest pre-tax in your 401k, you will have $100 that is yours and can grow tax-deferred until you retire.

Tax Savings from Investing in a 401k Plan




This is for illustrative purposes only and should not be viewed as tax advice. Be sure to consult with a financial advisor or tax professional for the latest rules and regulations.

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Advisor Corner

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# Tax Law Changes for 2011

A good mantra, for investing and for the rest of your life, is "Focus on what you can control." While most people are inclined to put taxes into the "out of my control" bucket, that doesn't have to be the case. Where taxes are concerned, it is always a good idea to consult with a tax professional. This article is intended only as a starting point to help you become informed about tax-law changes; it does not constitute tax advice. Some of these changes have an impact only on those in very high tax brackets, while others affect individuals of all income levels.

Social Security Payroll Tax Holiday: Social Security payroll taxes have dropped from 6.2% to 4.2% for 2011, giving an effective boost in pay to all workers. (As in the past, you won't pay Social Security tax on any earnings over a certain level--currently $106,800.) This provision is designed to get people out there spending, but a better idea, assuming you can afford it, is to divert that money to another retirement fund: your own. Increase your 401(k) plan contribution as close as you can to the annual limit; in 2011, that limit remains $16,500 for those under 50 and $22,000 to those over 50. And if you're already funding your 401(k), 403(b), or 457 plan to the max—or if you would rather save outside the confines of your company plan—you can direct that money to an IRA instead. IRA contribution limits are also unchanged from 2010: $5,000 for individuals under 50 and $6,000 for those over 50.

Alternative Minimum Tax: Toward the end of 2010, Congress put in place a so-called patch to keep a new group of taxpayers from having to pay the alternative minimum tax, a parallel tax system that disallows many of the credits and deductions that taxpayers are entitled to under the conventional tax system. That's good news, but if you've fallen into the AMT zone in the past, the latest patch isn't likely to keep you out of it. However, by taking steps to control your AMT-subject income and managing your deductions, you may be able to reduce your AMT tax hit. Some key strategies that you can employ include carefully managing the exercise of stock options (a well-versed tax advisor should be able to help with this) and watching out for private-activity municipal bond funds, which aren't taxable under the conventional tax system but are for the purposes of AMT.

Dividend Tax: Through 2012, the tax on qualified dividends remains at zero for taxpayers in the 10% and 15% tax brackets, and is 15% for all other taxpayers.

Long-Term Capital Gains Tax: Through 2012, taxpayers in the 10% and 15% brackets will not owe capital gains tax on the sale of assets they've owned for more than one year. Long-term capital gains tax rates remain at 15% for all other taxpayers. Short-term capital gains are taxed as ordinary income.

Estate Tax: Although the federal estate tax was set to jump to 55% for estates of more than $1 million in 2011, last-minute Congressional maneuvering resulted in a much less onerous rate for people who die with a lot of assets. The top estate tax rate is 35% for 2011 and 2012, and it only affects those who have amassed estates of more than $5 million. Those who inherit assets will also once again receive a step-up in the cost basis of those assets, meaning that the inherited assets are valued at their fair market value as of the decedent's death.

Given the more generous estate-tax limits, you may be assuming that a visit to your estate-planning attorney isn't necessary, but even if you don't anticipate that you will ever amass $5 million in assets, there's more to creating an estate plan than sidestepping taxes. A properly crafted estate plan will detail how you would like your assets distributed after you are gone. Gift Tax: The annual gift-tax exclusion stays the same as it was in 2010: $13,000. That means you can gift $13,000 apiece to an unlimited number of people this year without having to worry about a gift tax or even fill out the gift-tax paperwork.

# How to Handle Beneficiary Designations

Designating beneficiaries for your company retirement plan, life insurance policies, and other assets might seem like a no-brainer. Chances are you would like those near and dear to you to inherit any money you've accumulated during your lifetime, so making sure that happens should be as simple as writing their names on the appropriate forms, right? Well, if only it were that simple. Naming beneficiaries can be more complicated than you might think, and it's a decision that may have significant repercussions for your loved ones.

Know the Basics: You can name almost anyone, or anything, as your beneficiary, including individuals, charities, and trusts. However, it is important to note that children under the age of majority—18 or 21, depending on the state in which you live—cannot be named as beneficiaries of life insurance policies, retirement plans, or annuities. If a beneficiary is not designated, assets will have to go through probate, which can be a lengthy and costly process. Also, be aware that beneficiary designations will override bequests you've made in your will, so please do not rely on your will to sort out these issues. This leads to our second point.

Keep Your Designations up to Date: It would be advisable to review your beneficiary designations on a regular schedule, ideally as part of an annual review of your finances. Major life events, such as a marriage, a divorce, the birth of a child, or the death of a loved one may require that you make changes to your designations. Don’t procrastinate on this, as it may end up affecting others' lives. Moreover, you'll also want to review your designations if you or your employer have recently switched retirement-plan or insurance providers. You should not assume that the beneficiaries you specified with your previous provider will automatically carry over to the new one.

Bear in Mind the Tax Consequences: If you decide to designate someone other than your spouse as the beneficiary of your company retirement-plan assets, he or she may have to take mandatory distributions from that plan and, in turn, pay taxes on the money. Your spouse, on the other hand, will be able to roll over your retirement-plan assets into his or her own individual retirement account (IRA) and won't have to pay taxes until distributions begin. There can also be estate taxes to keep in mind if you name a beneficiary other than your spouse. Needless to say, it would be in your best interest to speak with a tax advisor or someone who specializes in estate planning to go over possible tax ramifications.

Be Specific: It pays to be as specific as possible when designating beneficiaries. Most beneficiary designation forms allow you to name multiple primary and contingent beneficiaries and to specify what percentage of assets you'd like distributed to each upon your death. For example, you can state: “I hereby designate my wife, Jane Smith, as primary beneficiary” or “I hereby designate my two children, John Smith and Allison Smith, as contingent beneficiaries, with the proceeds to be divided equally among them.” Of course, it is recommended that you discuss these important matters with your family members beforehand, so that they are prepared and know what to expect.

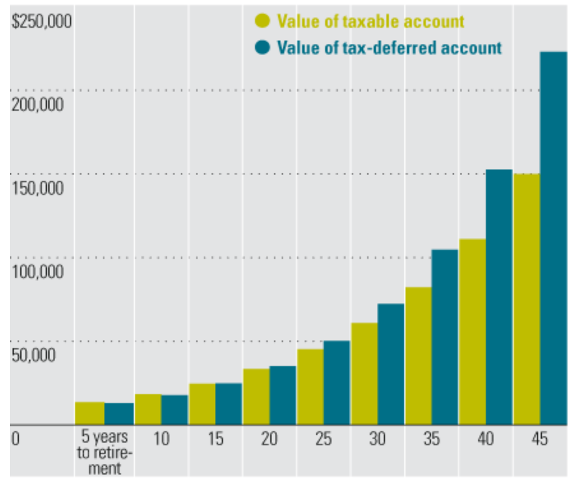
You Can Use a Legal Trust as a Beneficiary: What if you are in a situation where you can’t (or you don’t want to) name a person as a beneficiary? You can use what is called a legal trust. A trust means that you don’t leave the money directly to the beneficiary, but to an institution (such as a bank) who manages it for the beneficiary. This is especially useful when minor children or disabled relatives are involved. A trust can be revocable (you can change the provisions later), or irrevocable (can’t be undone).

# Take Advantage of Tax-Deferred Accounts

One of the main reasons why retirement accounts are so beneficial is the power of tax deferral. In a tax-deferred investment vehicle such as a 401(k) plan or an IRA, your earnings are not taxed until you begin withdrawing money from your account in retirement. Consider the image. A hypothetical value of $10,000 is invested in both a taxable and a tax-deferred account. The difference in value between the two accounts becomes quite substantial after 20+ years. For investors with a long investment time horizon, a tax-deferred portfolio is an excellent choice.

Please keep in mind that once you begin to withdraw money from your retirement account, you will be taxed accordingly. However, since you will most likely earn less in retirement, withdrawals from a deferred portfolio may be taxed at a lower rate.

Benefits of Deferring Taxes




Withdrawals of tax-deferred accumulations are subject to ordinary income taxes. A 10% federal tax penalty may apply to withdrawals made before age 59½. Returns and principal invested in stocks are not guaranteed.

Source: This hypothetical example is for an investor in the 28% bracket using the 2010 tax code (estimated to become the 31% tax bracket in 2013). $10,000 is invested in stocks at the beginning of year 1 (2011). Assumes an 8% annual total return (6% price return and 2% income return) and a 15% tax rate on capital gains and dividends in year 1 (2011) and year 2 (2012), after which the rates revert to 20% and the investor's marginal tax rate, respectively. The investment is taxed at a 28% marginal tax rate in year 1 (2011) and year 2 (2012), and then reverts to 31%. Taxes are assessed yearly on the taxable account but only at the end of the period on the tax-deferred account. Estimates are not guaranteed.



WHITE·HOUSE
FINANCIAL & INVESTMENT SOLUTIONS, LLC

White House Financial & Investment Solutions, LLC
114 SOUTH MAIN ST, Suite 300
CHELSEA, Michigan 48118

www.whitehousellc.com

Tel:734-433-1670
Fax:734-433-1671