SUMMARY

Beginning in 2011, high income and high net worth taxpayers will see their income tax rates rise in order to help close Federal budgetary shortfalls. A confluence of events – the “Great Recession” of 2008-09, the expiration of 2001-03 tax laws and the enactment of Health Care Reform – may result in substantial changes to the financial planning and investment management environment.
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Introduction

For most individuals, there will be substantial changes to the tax environment over the next three years, and while 2010 still has more than its share of uncertainty, one thing is for certain: for high income earners and high net worth individuals, tax rates will rise. We just don’t know whether it will be due to the expiration of existing laws or the enactment of new ones. Fast-forward to 2013, and additional tax increases associated with “Health Care Reform” will apply. The purpose of this paper is to help clarify many of the changes and perhaps more importantly, to help you understand their impact.

There are two primary sources of these changes. First, at a minimum, the increase beginning in January 2011 will be due to the fact that virtually all of the 2001-2003 tax cuts expire, or “sunset,” on December 31, 2010. If this happens, the 2011 tax code will look just as it did in 2000. Alternatively, current Administration proposals for the 2011 tax year, if enacted by Congress, would result in substantial changes to those laws, including rearranged tax brackets and modified deduction formulas, among other things. The second source of tax increases results from the enactment of the “Health Care Reform” passed earlier this year, most of which are set to take effect in 2013 and later.

In addition to the income tax environment, there will be more changes in 2011 to the transfer tax system (estate, gift and generation skipping transfers). There is even more uncertainty in this area given that 2010, known as “the year without an estate tax,” is constantly being threatened by the possibility of a “retroactive” law reinstating the estate tax back to the beginning of the year. Several high-profile cases including The Estate of Dan L. Duncan, a Texas pipeline tycoon who died in late March of this year will present Congress with its fair share of challenges. His estate is estimated to be worth $9 billion, and it would therefore generate an estate tax liability of nearly $4 billion under the 2009 system – foregone under the 2010 regime. Granted, under the 2010 system, some of the “foregone” estate tax gets recovered over time through capital gains taxation if and when his heirs sell the assets they have inherited based on the original tax basis. The Estate of George Steinbrenner is also estimated to be worth $1.15 billion. Combined, that’s approximately $4.5 billion of “lost” estate tax revenue.

One can accept the changes as a “given” in light of the current environment, but we recognize that the impact to an individual’s financial situation could be meaningful, and so we ask ourselves, “What can we do about it?”

In general, you might consider 1) recognizing discretionary income in 2010 (stock options and restricted stock), 2) deferring less income where possible, 3)
converting IRAs to Roth IRAs where appropriate, 4) deferring deductible expenses into future years, 5) holding recognition of losses until future years, and 6) postponing major estate planning revisions until later in 2010 or early 2011 (if possible).

The discussion of how these laws impact small businesses and their owners is a meaningful but separate one, so the focus here is only on the individual taxpayer.

**Background**

When enacted, the “Bush-era Tax Cuts” (EGTRRA and JGTRRA) were designed to expire, or “sunset,” on December 31, 2010, because of budgetary constraints; as a result, the tax code will simply revert to the way it was before the laws were enacted. It was assumed that in the intervening time, Congress would work to enact new code to take effect at the laws’ expiration. That has not happened yet. Therefore, the tax regime in effect at January 1, 2011, will be one of two things: 1) the old law reinstated, or 2) if enacted, a new set of code yet to be determined.

Separately, in March 2010, Congress passed what we now commonly refer to as “Health Care Reform.” These new laws will provide health care coverage to an estimated 32 million uninsured Americans once it is fully implemented by 2019, with a total, projected deficit reduction of $124 billion over ten years, according to the Congressional Budget Office. As various aspects of the law are implemented over time, most of the revenue raising provisions, i.e., taxes, will take effect in “tax years ending after December 31, 2012.” The two primary sources of funds under this new law are 1) an increase to the Medicare Part A (“Hospital Insurance”) tax rate on wages over $200,000 of 0.9% (from 1.45% to 2.35%) and 2) a 3.8% surtax on “unearned” income, or “net investment income,” if earned income exceeds that same threshold.

Whether we simply revert to the old tax schedules or if the current Administration’s proposals pass through Congress, income taxpayers in the highest bracket will see their marginal rate go from 35% back to 39.6%; there may also be some significant changes to the size of the brackets to which those rates are applied. Additionally, current proposals also contain measures to reinstate the “personal exemption phase-out” and the “limitations on itemized deductions.” All that means is the more you make, the less you can deduct. Lastly, the estate tax will rise from zero percent in 2010 (if nothing is enacted retroactive to January 1, 2010) to perhaps 55% for estates over $1,000,000 (and even higher rates for estates over $10 million). Of course there is also the Alternative Minimum Tax (the “AMT”). Absent the temporary patches that Congress has utilized in the recent past, the AMT exemption would revert to the nominal levels established in 1993, and the AMT could affect almost a third of all taxpayers according to some estimates.

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3 See July 2009 RTS report titled, “Roth IRA Conversions in 2010,” available upon request.
4 $250,000 for Married Couples Filing Jointly and Surviving Spouses; $125,000 for married individuals filing separately; and $200,000 for all other filers. “Net Investment Income” is defined later in the report.
Income and Transfer Tax Changes in 2011

A “Sunset” or the “Dawn of a New Era”?  

The following chart (Figure 1) represents the marginal tax brackets (for Married couples Filing Jointly, or “MFJ”) at a particular level of taxable income (vertical axis) under three different scenarios: 1) the current 2010 tax brackets (left column), 2) the 2000 tax brackets, which would take effect under the “sunset provisions” (middle column), and 3) current White House Budget Proposal tax brackets for 2011 (right column). To read the chart, find your level of taxable income along the vertical axis, then move to the right to determine which tax bracket you currently fall into and compare it to which tax bracket you could be in for 2011 under either scenario. For example, a married couple filing jointly with taxable income of $350,000 in 2010 is in the 33% tax bracket. In 2011, that same couple could be in the 39.6% bracket if the “sunset” provisions take effect, or if current proposals are passed, they would be in the 36% tax bracket. Conversely, a couple with taxable income of $230,000 could see their tax rate fall from 33% in 2010 to 28% in 2011 under White House proposals. Lastly, those with the lowest taxable income could see their marginal rate go from 10% to 15%, under the sunset provisions, a 50% increase.

![Figure 1: Comparative Marginal Tax Brackets 2010 v. 2011](image)

Obviously, this report cannot examine every situation to determine whether or not a particular taxpayer would experience an increase or a decrease in tax rates. However, the

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5 For Married Couples Filing Jointly. While the chart only shows income to $500,000, the 35% and 39.6% brackets are the highest rates. Income above that amount is also taxed at the highest marginal rate.
Administration’s proposals, which have been fully disclosed, are deliberately intended to shift the majority of the tax burden onto higher wage earning taxpayers.

In fact, according to the Tax Policy Center\(^6\), “the proposals would increase income taxes for about 3.4% of all taxpayers” with most of the increase affecting those at the upper end of the income scale. The reduction in tax revenues from the wider 28% bracket would be fully offset by the rate increases at the upper end. The exception to that rule is for Heads of Household who may be in the 28% bracket under the current system, but may see their marginal rate rise to 36% by 2011. In addition to rate increases for those in the upper tiers, the proposals also include the reinstatement of personal exemption phase-outs and limitations on itemized deductions (discussed later), which may also increase one’s tax liability.

**Capital Gains and Qualified Dividends**

With the expiration of JGTRRA on December 31, 2010, both capital gains tax rates and dividend tax rates\(^7\) will revert to 2000 levels unless there is a new agreement. Figure 2 below illustrates the potential changes in both of those rates. Short-term capital gains and taxable interest income will still be grouped with ordinary income and subject to the same rates under both the “sunset provisions” (middle columns) and the White House budget proposals (right columns). It is important to note, however, that the average tax rate on dividends has been around 40% historically, with no discernable impact on the ownership levels of dividend paying stocks, although we did see a few new “equity-income” mutual funds in 2002-3. There were a lot of factors at work during that time frame that could have resulted in the same outcome, but it is realistic to assume that a reversion to historic tax levels on dividends (in the bad-case scenario) will not force another change in the ownership levels of dividend-paying stocks.

![Figure 2: Capital Gains and Dividend Tax Rates](image)

As with any investment decision, the tax considerations are only a component – albeit many times a material component – of the decision-making process. Certainly, we

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\(^6\) The Tax Policy Center (or “TPC”) is a joint venture of the Urban Institute and the Brookings Institution (http://www.taxpolicycenter.org).

\(^7\) Specifically, long-term capital gains and “qualified dividends.”
would suggest taking an integrated, holistic approach when deciding whether or not to make changes to a portfolio in light of an uncertain tax environment.

**Personal Exemption Phase-out and Limitations on Itemized Deductions**

Perhaps just as meaningful as the changes already discussed are the reinstatement of “personal exemption phase-outs” (or “PEP”) and “limitations on itemized deductions.” The ability to take personal exemptions begins to decline at $254,450 for married couples filing jointly based on inflation-adjusted 2009 benchmark levels and is completely eliminated after a $122,500 increase from there. For itemized deductions, the threshold is the same for the respective filing statuses. In other words, the expiration of certain laws at the end of 2010 will re-usher in significant “marriage penalties” since the MFJ threshold does not equal two times that of the single filer. Of course the limitations on deductions are applied only in the “regular tax,” not the AMT. Essentially, these two changes each add about 1% to the taxpayer’s effective tax rate for the highest income taxpayers.

Not only do phase-outs come back in 2011, but also under the Administration’s budget proposal, the value of those itemized deductions will be capped at 28%. Under the current system, taxpayers can offset income by the amount of allowable deductions. The net income is then subject to tax at the current schedule. The implication is that a deduction offsets income tax owed by an amount equal to the marginal rate times the amount of deductions. For example, if a taxpayer in the 15% tax bracket itemizes deductions of $5,000, that taxpayer saves 15% of $5,000 on the final tax bill, or $750. If a 35% marginal rate taxpayer has deductions of $5,000, the savings is 35% of $5,000, or $1,750.

By capping deductions at 28%, the 36% and 39.6% marginal rate taxpayer is not reducing income on a dollar-for-dollar basis – thus making certain deductions less valuable (or more expensive) on an after-tax basis. For example, under the current system, if a top marginal rate taxpayer makes a $1 charitable donation, it winds up costing just $0.65 because giving that dollar away reduces taxable income by a dollar – and thus saves $0.35 on the tax bill. Under the proposed budget, the after-tax cost of making that same charitable contribution is almost a third higher (assuming the top marginal tax and a 28% cap) to the highest bracket taxpayer.

**Estate Tax**

Since the early 2000’s, we have seen both the estate tax exclusion amount rise and the estate tax rate fall as part of EGTRRA/JGTRRA. Originally, the purpose of the law was to gradually eliminate estate tax over time. In the absence of an estate tax, the “Carry Over Basis” System would take its place. In reality, the law and its sunset provisions have created an environment full of uncertainty and political debate.

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8 Also known as the “Pease Limitations” – named after Donald J. Pease (D-OH) who served as a member of the U.S. House of Representatives from 1977-93 and is credited with creating legislation within the U.S. Internal Revenue Code (“IRC”) whereby taxpayers who made excess amounts of adjusted gross income would gradually lose their itemized deductions as income rises.
The exclusion amount is simply the amount one individual can exclude from the value of an estate – any amounts above that are taxable at the estate tax rate. When set up properly, a married couple can benefit from two exclusions. Once taxed, assets in the estate are given a new cost basis equal to their value on the date of death – a "step-up" in basis. In the Carry Over Basis System, beneficiaries simply inherit a decedent’s assets at the original cost basis, *i.e.*, no step-up. Therefore, tax revenue isn’t realized at the date of death then, but rather at the time the beneficiaries realize a gain (much like the treatment of a gift from one person to another during life, except for the holding period). In 2011 however, if the current law sunsets, we will see a return of the 55% estate tax applied to amounts in excess of $1 million.

### Recent Changes to the Transfer Tax System

<table>
<thead>
<tr>
<th>Year</th>
<th>Estate Tax Exclusion Amount</th>
<th>Estate Tax Rate</th>
<th>Generation Skipping Tax (GST) Exemption</th>
<th>Lifetime Gift Exclusion Amount</th>
<th>Gift Tax Annual Exclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$1,000,000</td>
<td>50%</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>2003</td>
<td>$1,000,000</td>
<td>49%</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>2004</td>
<td>$1,500,000</td>
<td>48%</td>
<td>$1,500,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>2005</td>
<td>$1,500,000</td>
<td>47%</td>
<td>$1,500,000</td>
<td>$1,000,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>2006</td>
<td>$2,000,000</td>
<td>46%</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>2007</td>
<td>$2,000,000</td>
<td>45%</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>2008</td>
<td>$2,000,000</td>
<td>45%</td>
<td>$2,000,000</td>
<td>$1,000,000</td>
<td>$13,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
<td>45%</td>
<td>$3,500,000</td>
<td>$1,000,000</td>
<td>$13,000</td>
</tr>
<tr>
<td>2010</td>
<td>“Carry-Over Basis” System</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>2011</td>
<td>$1,000,000</td>
<td>55%(^{10})</td>
<td>$1,000,000(^11)</td>
<td>$1,000,000</td>
<td>$13,000</td>
</tr>
</tbody>
</table>

Table 1: Changes to Transfer Taxes under EGTRRA

With respect to the whole transfer tax system, so much remains unclear at this point, that planning is difficult. However, that does not eliminate the need to understand what would happen if your will were to take effect right now; the impact on your family’s estate could be meaningful. For example, some wills contain “formula provisions” that are a function of “the maximum amount not subject to estate taxes.” Applying that formula when there is no estate tax may not achieve the intended results under the current system. Such a formula may shift an entire estate into a trust for the benefit of children rather than carving out an amount that might otherwise pass to a trust established for the benefit of a surviving spouse – or vice versa. In addition to under- or over-funding a particular trust, if the estate tax does return, a surviving spouse’s taxable estate (and thus estate tax bill) may now be larger than originally anticipated. With respect to those formulas and in an attempt to provide some relief, some states have enacted temporary laws that would allow a will to work as though the 2009 laws were still in effect.

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9 Technically, the basis of the property is the *lesser of* (1) the decedent’s adjusted basis, or (2) the fair market value of that property on the date of death. So in effect, there exists the possibility of a “step-down” in basis. There are additional rules for basis adjustments to things like Community Property, Qualified Spousal Property, and Pecuniary Bequests that are beyond the scope of this report.

10 60% in some cases on limited amounts in estates worth $10 million or more. Plus the return of the state estate and inheritance tax credit.

11 Indexed for inflation, the amount could be $1,340,000 in 2011.
On a side note, it is unfortunate that charitable organizations may be one of the unintended victims of these changes, especially during such challenging economic times. Compounding the impact of the recession on philanthropy is the fact that charitable giving is often part of an income tax or estate plan to otherwise minimize one’s tax liability. *Inter vivos* gifts may be more valuable past 2010 as income tax rates rise (provided phase-outs have no impact), and testamentary gifts have little if any tax advantage in the absence of an estate tax, perhaps making charitable giving during 2010 less financially rewarding.

**Generation Skipping Transfer ("GST") Tax**

With respect to the tax imposed on transfers to individuals more than one generation removed, we essentially act as though the GST rules “had never been enacted” for calendar year 2010 except in certain cases of transfers to a GST exempt trust. Then again, beginning on January 1, 2011, we are supposed to act as though EGTRRA/JGTRRA “had never been enacted.” This conflict has made many aspects of its application extremely difficult. Look for further clarification in future updates or reports.

If there is reason to believe that one’s estate plan would not be effective in the current environment, steps should be taken to address the issues in the near-term. Where possible though, decisions regarding estate plans should probably be postponed until year-end, at which time we hope there will be more clarity and certainty of the overall system.

**Summary: Income and Transfer Tax Changes**

The projected increase in an affluent taxpayer’s “Effective Tax Rate” will result from several changes; this chart zooms in on the top 20th percentile (or quintile) of taxpayers to detail those various sources. For example, taxpayers in the top 1st percentile of all taxpayers (middle bar) will see their effective tax rate rise (the over-all “net rate” having given effect to progressive tiers and multiple sources) from 28.7% to 32.7%, an increase of about 4 percentage points (vertical axis). The bulk of that increase (1.4%) is the result of the “Higher Top Rate”; 0.9 is from increased capital gains tax; 0.7 from “PEP”; 0.6 from the return of dividend taxes to ordinary rates; 0.2 from the elimination of the 10% tax bracket; and finally, 0.1 from the increased estate tax rates. Still, other groups are affected by things like the “Marriage Penalty,” restricted credits or the AMT.
Health Care Reform

Amid all of the “big news events” this year, one of the biggest was the passage of “Health Care Reform.” A combination of two laws signed in March 2010, these new laws will provide health care coverage to an estimated 32 million uninsured Americans. Many high income and high net worth taxpayers will be significantly impacted by the new taxes imposed by the two laws. The two primary sources of funds under the Reform package are 1) an increase to the Medicare Part A (Hospital Insurance) tax rate on wages over $200,000 ($250,000 – MFJ) of 0.9% (from 1.45% to 2.35%) and 2) a 3.8% surtax on “unearned” income, or “net investment income,” if earned income exceeds $200,000 ($250,000 – MFJ). Many provisions of the package are phased in until fully implemented by 2019, but most of the new taxes are imposed “for tax years ending after December 31, 2012” (that’s 2013 to most).

Hospital Insurance

There will be an increase of 0.9% to the tax rate on wages over $200,000 for individuals and $250,000 for married couples filing jointly. That means the current rate of 1.45% goes to 2.35%, and there is no cap to the amount of taxable wages above the respective thresholds. The tax is imposed on the employee, not the employer, and will likely be withheld from your paycheck. The thresholds are not indexed for inflation.\(^\text{12}\)

For example, if our example married couple on page 5 earns wages of $350,000 in 2013, $100,000 will be subject to an additional $900 ($100,000 x 0.9%) of “Hospital Insurance” tax – in addition to the $5,075 ($350,000 x 1.45%) already being collected for a total of $5,975. This amount is separate and distinct from the income tax.

Unearned Income Surtax

The other tax under the Reform is a new 3.8% tax on “unearned income” for “higher-income taxpayers,” including trusts and estates.

- “Unearned Income,” or “Net Investment Income” is defined as gross interest income (other than tax-exempt income), dividends, annuities, royalties, and rents. It also includes capital gains and certain income from partnerships and S-Corporations. The income can be offset by expenses directly related to such income, but not by ordinary business losses or expenses that are otherwise deductible. Income from certain qualified retirement plans, Traditional IRAs and Roth IRAs is NOT included in net investment income.
- A “higher-income taxpayer” is one whose Modified Adjusted Gross Income exceeds $250,000 for married couples filing jointly or surviving spouses, $125,000 for a married person filing separately, or $200,000 for all others. This threshold is not indexed for inflation.
- In the case of a trust or an estate, the threshold is reached when the entity reaches the highest income tax rate (in 2010, that would be $11,200), but this threshold is indexed for inflation.

\(^\text{12}\) As income levels rise over time, this may become a relatively “low amount,” potentially including more and more taxpayers, similar to what was seen with the AMT.
Using the same married couple in the prior example (earning wages of $350,000 in 2013), but adding $100,000 of net investment income through interest, dividends and long-term capital gains, the couple will have an additional Medicare Surtax due of $3,800 ($100,000 x 3.8%) – in addition to the tax owed due to the nature of the “net investment income” at rates of 39.6% or 20% depending on the tax at the time. Essentially this means that for higher-income taxpayers, the dividend tax rate could go from 15% in 2010 to either 39.6% (2000 rates) or 20% (proposed) for the years 2011 and 2012, then to 43.4% or 23.8% in 2013, respectively.

Other Provisions

Cadillac Plans
Health Care Reform will also impose a new tax on insurance companies who provide “high-cost” health care coverage (or a “Cadillac Plan”) to individuals. A 40% excise tax will be imposed on the excess cost of the coverage over pre-determined threshold levels of coverage. There are exceptions for coverage on “high risk” employees (e.g., fire fighters, longshoremen and police) and for those over 55 years of age, and the premium thresholds may be increased by an “inflation factor.” This provision will take effect in taxable years beginning after December 31, 2017, presumably to give health plans more time to benefit from possible cost savings from other reform measures, and there are provisions if costs rise more than expected during that time.

Itemized Deductions
To the extent medical expenses exceed 7.5% of your Adjusted Gross Income (or “AGI”), they are deductible. Beginning in 2013, however, that threshold rises to 10% of AGI. The law will waive the increase on people age 65 and older from 2013 through 2016.

Flexible Spending Accounts (or “FSAs”)
Where prior law allowed for the reimbursement of over-the-counter drugs (including things like aspirin or contact lens solution) from one’s FSA, under the new law, reimbursements will only be allowed for “drugs that are prescribed by doctors and insulin.” This provision will take effect in 2012. The penalty on distributions of unused balances in these plans will rise from 10% to 20% (effective 2012). Lastly, the amount of pre-tax income that can be set aside in an FSA will be capped at $2,500 (indexed for inflation) beginning in 2013.

Planning Opportunities
Confused? So are a lot of people. There is a publication by the Joint Committee on Taxation that lists 69 tax provisions that expire on December 31, 2010; by 2011, that

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13 A high-cost health plan is defined as costing more than $10,200 for an individual or $27,500 for a family, including worker and employer contributions to flexible spending or health savings accounts; it does not include stand-alone vision or dental benefits.
number drops to 8. But there are still some things that you should and shouldn’t consider in order to prepare for these changes.

CONSIDER

- Recognizing discretionary income in 2010 (stock options and Restricted Stock Units) when tax rates are presumably lower.
- Deferring less income where possible (non-qualified deferred compensation plans, for example). Take the income now at 35% tax instead of future years when your tax rate may be higher.
- Realizing capital gains in 2010 at 15% instead of 20% or 23.8%. Sell low-basis, appreciated assets and repurchase the same or similar assets as part of your own “step up in basis” program. This could be modified for older people where death may be imminent.
- Converting IRAs to Roth IRAs where appropriate.
- Deferring certain deductible expenses into future years, like Charitable Contributions and Unreimbursed Employee Expenses, where possible, and when not impacted by the phase-out or caps of itemized deductions. Consider transferring assets to other family members who can in turn make better use of the charitable deduction. The exception to the “deferral advice” might be for medical and dental expenses; you may want to take those when the limit is 7.5% instead of 10%. The “breakeven analysis” in either case is easy to do.
- Holding recognition of losses until 2011.
- Postponing major estate planning revisions until later in 2010 or early 2011 (if circumstances allow it) when there should be more visibility into the future.
- Making “leveraged” gifts using strategies like GRATs.

DON’T

- Be motivated to make investment decisions simply based on the tax consequences. Buy good investments and sell the bad ones because they are.
- Make any more taxable gifts in excess of the $1 million exclusion until there is more clarity in the area of transfer taxes. Annual Exclusion Gifts, however, can still be very effective.

Risks

No financial planning strategy is final, and there is no “universal advice” that is appropriate for every taxpayer. The environment in which we operate is constantly changing, and we cannot always predict new developments. Consult with your tax advisor and legal counsel to determine your own approach. Factors that could pose a risk to any strategy include:

- These laws could be eliminated or repealed retroactively,
- An overhaul of the tax code (either the regular tax, the Alternative Minimum Tax or the Estate Tax or a “VAT Tax”) could change all of the rules, and
- Personal facts and circumstances may dictate a different course of action.
Conclusion

There is an unprecedented amount of uncertainty in the areas of income and estate planning. The consequences of some decisions or indecisions can be more costly than ever. Thoughtful analysis has never been more worthwhile. We at Round Table Services, LLC look forward to working with you to determine if any of these strategies is right for your particular situation.

Round Table Services, LLC
319 Lenox Avenue; Westfield, NJ 07090
Telephone: (908) 789-7310
Facsimile: (908) 789-7312
www.roundtableservices.com


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