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### **Hope and Anxiety in Financial Planning**

Ah, Springtime. It is a time of great hope and anxiety, just like our current financial planning environment. There is the hope that the government will have investor friendly policies, yet there is concern that this may not materialize.

At this time of year there is hope for every baseball fan. As the season starts you still believe that this is the year that your team will win it all. For golfers, you can still dream that your new driver will deliver on its promise of getting you to hit the ball farther and straighter than ever before.

Spring also brings the anxiety of tax season: *The Wall Street Journal* reported that the dread of gathering tax information even puts the IRS Commissioner on edge. For parents and high school seniors, there is another cause of unease as they anxiously wait to hear where they will be attending college next year.

In this piece, we will explore the current personal financial planning landscape in the hopes of shining light on opportunities and avoiding potential pitfalls.

### **Income Tax**

The budgetary gimmickry used in Washington over the last ten years has created much uncertainty. The concept of “sun setting” has been a political means to get a bill through Congress but it is creating nervousness for people who are trying to plan their financial lives. President Bush has pushed hard to make the 2003 tax cuts permanent, yet due to his current approval ratings, he was only able to extend the cuts thru 2010.

I recently polled my financial planning class at New York University and asked what they thought the capital gains rate might be after 2010. They were split down the middle: half thought rates were going up and the other half thought they would remain the same. Interestingly, no one thought that rates would decline.

Currently, qualified dividends and long-term capital gains are being taxed at 15%. This rate is set to expire, or “sunset”, after 2010. Therefore, if Congress does not address this situation, rates will revert to their pre-2003 levels (see chart below: dividends could be taxed as much as the top marginal tax rate of 35%). This uncertainty could be a good reason to consider accelerating the sale of a business or to diversify out of a concentrated stock position.

	<u>2006 - 2010</u>	<u>2011 and after</u>
LT Capital Gains Rate	15%	20%
Qualified Dividends	15%	35%

Another concern among taxpayers is the Alternative Minimum Tax (“AMT”). This stealth tax is hitting retirees and those who live in high tax jurisdictions especially hard (i.e. CT, MA, NY, NJ, and CA). The AMT is trapping more and more people every year because it was not indexed for inflation when originally created in 1969. There is considerable debate in Washington about this tax, though it is very difficult for Congress to change because of the increasing amount of revenue that it is raising. The AMT is estimated to raise \$1.2 trillion over the next 10 years. For Washington to cut this tax they would have to make up the revenue elsewhere. As investors, it is critical for you to know if you are subject to the AMT. If you are subject to the AMT, you may need to re-position your fixed income portfolio to maximize after-tax returns. Our fixed income managers can add significant value in managing this issue.

### Estate and Gift Tax

There is even more uncertainty in this area. I’m sure you have already heard the jokes about planning your death in 2010 when the estate tax is scheduled to disappear for the year. While we are always in favor of good planning, we are certainly not advocating this strategy. We do want you to be aware of the vacillations in the estate tax when drafting your will. Also, keep in mind that it is only the estate tax that is changing (see chart below): Under current law, the lifetime gift tax exclusion is scheduled to remain at \$1m (\$2m if married). This means that a married couple could make taxable gifts of up to \$2m before having to write a tax check to Uncle Sam. While we do not pretend to have a crystal ball to be able to predict whether there will be an estate tax or not, we can say that if you are ready to start shifting assets to your children, it would be best to start now with the right structure.

<u>Year</u>	<u>Estate Tax Exclusion \$</u>	<u>Gift Tax Exclusion \$</u>
'06 - '08	2,000,000	1,000,000
2009	3,500,000	1,000,000
2010	Repealed	1,000,000
2011	1,000,000	1,000,000

One other gift tax planning strategy that is often overlooked is the use of annual exclusion gifts (\$12,000 if single; \$24,000 if married). This is the amount that you can give each person every year, without eroding your lifetime unified credit equivalent amount (\$1m if single; \$2m if married).

For example, if a married couple gifted \$24,000 to a child every year for 20 years, earning an annualized rate of return of 8%, they would save \$533,768 of estate tax. And, the more children you have, the more you will save!

<u>Annual Gift \$</u>	<u>Years</u>	<u>Annual Growth</u>	<u>Value after Term \$</u>	<u>Estate Tax Savings @ 45%</u>
24,000	20	8%	1,186,150	533,768
48,000	20	8%	2,372,300	1,067,535
72,000	20	8%	3,558,450	1,601,303

### **Rising Interest Rate Environment**

A rising interest rate environment has changed the effectiveness of certain estate planning strategies. Charitable remainder trusts are on the rise, while the use of grantor retained annuity trusts is falling.

You may recall that charitable remainder trusts (“CRT”) were popular back in the dotcom era before the bubble burst. A CRT allows investors with highly appreciated assets to diversify their portfolio without paying capital gains tax. It also allows them to generate an income stream and receive a tax deduction. Now that people once again have appreciated assets and the interest rate used to value the income stream has risen, CRTs are back. I recently co-authored an article for the *Journal of Financial Planning* which explores this topic in greater detail. A copy can be found on our website at [www.masseyquick.com](http://www.masseyquick.com).

Qualified Personal Residence Trusts (QPRTs) also offer benefits in a higher rate environment. This is a viable strategy if you want to transfer an interest in real estate to family members in the future at a reduced gift tax value today. There is a lower gift tax valuation because you calculate the present value of the amount that will eventually pass to family members using current interest rates (IRS 7520 Rate). QPRTs are a better strategy in a higher rate environment, though when engaging in an estate planning strategy you always want to use assets that you think will appreciate. Given the softening housing market this may be a strategy to put on the back burner.

Grantor Retained Annuity Trusts (“GRATs”) have been a very popular technique over the last few years because the IRS hurdle rate (7520 rate) was at historic lows. Investors believed it would be relatively easy to beat these hurdle rates to generate positive estate planning results. As rates have steadily inched up, individuals have felt less confident about the ability to outperform the 7520 rate. A GRAT will not cause a negative estate

tax arbitrage because, if there is no appreciation, the grantor would get back what they contributed. However, there may be better strategies at this point in the interest rate cycle.

### **Charity**

Last year, in the wake of Hurricane Katrina, there was heightened attention to charitable giving. Fortunately, we were able to work with many clients to help them achieve their philanthropic goals and objectives: For some it was transferring appreciated securities directly to charity to get a fair market value deduction and to avoid the capital gains tax. For other clients it meant implementing more complicated, intergenerational strategies such as charitable remainder trusts, charitable lead trusts, and family foundations. An emerging trend in philanthropic planning is the use of real estate. Bear in mind that transferring appreciated real estate can be very complicated and requires getting the right team of advisors to execute the plan. However, the stellar appreciation in the real estate market is reason to consider this asset for your charitable endeavors.

### **Conclusion**

With all of the uncertainties across the current financial planning landscape and the unknown of where things might be heading, planning can be quite daunting. We would be delighted to share our ideas and experience on these topics in order to help you customize your own personal financial plan in accordance with your specific goals and aspirations.