

# Taxes, Taxes, Taxes

What You Should Know for 2010 and Beyond



BNY MELLON  
WEALTH MANAGEMENT

## Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

For better or worse, the U.S. tax code is about to get a major makeover. Expiring legislation, government demand for new revenue and the country's less-than-robust economic recovery are combining to put upward pressure on tax rates. That means investors—who have not seen a major tax increase in nearly two decades—may need to start thinking about taxes in a whole new way.

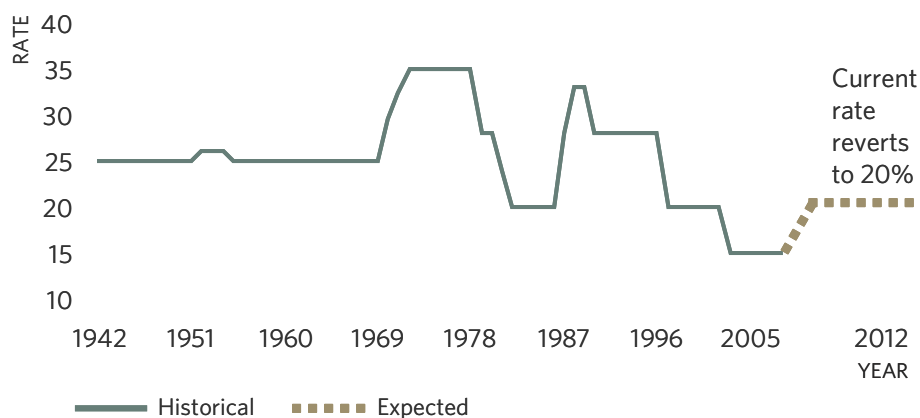
With so many factors at play, the exact nature of the coming tax changes is still uncertain. If Congress takes no action before year end, for example, multiple Bush-era tax cuts will expire on December 31, 2010, leaving taxpayers with not only higher estate taxes but also increased rates on capital gains, qualified dividends and certain income taxes.

Even if Congress does act, the growing deficit is whetting the federal government's appetite for new sources of revenue, making tax increases a likely default position. Add to that the problems of cash-starved states that must either raise taxes or continue slashing services, and the picture is clear. Taxes are going up, and it will likely be some time before U.S. investors see them come down again.

For many, this rising tax environment will be a big adjustment. Indeed, the last net federal tax increase was enacted in 1993, and capital gains taxes have remained at the current low rate for the past eight years, as illustrated in Exhibit A.

Exhibit A

### Capital Gains Tax Rate



Source: Institute for Policy Innovation Policy; *A Capital Gains Tax Cut: The Key to Economic Recovery*  
By: Stephen Moore and Phil Kerpen, Policy Report 164 October 2001  
*Past performance is no guarantee of future results.*

That means investors, who have lived through 17 years of declining taxes, are about to be confronted with a new tax landscape. Those who want to stay ahead of the changes can start preparing now, taking advantage of available tax breaks while they still exist, and building strategic flexibility into their future financial planning.

What can investors do? Given the likely tax scenario for 2011 and beyond, they may want to rethink not only the kind of investments that they own but also where they choose to hold those assets. The timing of the purchase and sale of securities certainly will become more important, as will the timing of major gifts. People may want to reconsider which assets are held in their retirement plans and which are owned in taxable accounts, and active management of tax opportunities, such as loss harvesting, should be an increased focus. Finally, estate plans may need some attention, both to avoid pitfalls created by changes in the law and to take advantage of opportunities before they disappear.

# Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

## Gone Today, Back Next Year

Whether Congress takes action or not, the estate tax — which temporarily disappeared for a year on January 1 — almost certainly will be back in 2011, but what form will it take? Many had expected Congress to pass legislation last year to keep the estate tax at 2009 levels. That would have set the estate tax exemption at \$3.5 million and established a top rate of 45%. Republicans, however, want an estate tax with a \$5 million exemption and a top rate of 35%. If Congress does nothing, the tax automatically will revert to the levels that would have existed if the Bush tax cuts had never been enacted — a \$1 million exemption and a 55% top rate. Finally, a proposed surtax could push that top rate even higher, to 60% for certain wealthy individuals. See Exhibit B for exemptions and tax rates from 2003 to 2011 and beyond.

With no agreement in Washington, taxpayers are left trying to plan around an uncertain future. First, they must dodge the black holes left in their planning caused by the disappearance of the estate tax; then they have to make sure that their plans are flexible enough to deal with any future scenarios. Some may be tempted to simply sit on the sidelines until the issue is clearly resolved in Washington, but there can be a big cost for waiting.

### Exhibit B

## Federal Estate and GST Exemptions and Rates

Year	Federal Estate and GST Exemption at Death	Maximum Federal Estate Tax Rate
2003	Estate Tax: \$1,000,000 GST Tax: \$1,120,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	No Tax - estate and GST tax repealed	No Tax - gift tax equal to top individual tax rate of 35%
2011 and thereafter	Estate Tax: \$1,000,000 GST Tax: \$1,060,000 indexed from 2001	55% (plus 5% surtax on certain estates over \$10 million)

*Gift tax exemption is \$1,000,000 for all of the above years.*

In order to minimize tax pain, estate plans typically have relied on federal formulas to determine the amounts left to various heirs. For example, an estate plan that preserves the full federal estate tax exemption by leaving that amount to the kids might have made sense when the exemption amount was \$1 million back in 2003. At an exemption level of \$3.5 million, however, the surviving spouse could be effectively disinherited. Today — when there is no tax and no exemption — the same language might mean that the kids get nothing at all.

State laws create additional complications because these commonly reference federal statutes. For example, a resident of one state died leaving a sizeable estate to his wife through a qualified terminable interest trust (QTIP).

Such a trust is designed to give all income to a spouse for life — thus qualifying the trust for any marital deduction that might exist — while preserving the corpus of the trust for future beneficiaries. This is where the plan got into trouble.

The law that applies in the state allows marital deductions for QTIPs, but only when a QTIP election is made to reduce federal estate taxes as well. As there is no federal estate tax this year, there is also no federal QTIP election. As such, the entire estate will be taxable by the state, unless the state chooses to revise its rules.

## Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

With changes in the federal estate tax law imminent, people may be hesitant to pay for revising documents that may need yet another overhaul next year. In the meantime, however, they can arrange for appropriate language to be built into estate planning documents so that their plans work as intended no matter what Congress ultimately decides. Moreover, people may need to redo at least some of their documents to take advantage of opportunities that now exist but are likely to disappear by year end.

The generation skipping tax (GST), for example, was temporarily repealed at the same time as the estate tax. This tax is designed to prevent the wealthy from passing assets directly to grandchildren, thus avoiding transfer taxes that would have applied had those assets passed through each successive generation. With the tax gone for a year, however, wealthy individuals may choose to give significant amounts of money to grandchildren without having those gifts subject to the GST. Under current law, the only tax that applies would be the gift tax, which in 2010 dropped to 35% from last year's 45% on any amounts over a \$1 million lifetime exemption. To hedge against the uncertainty of a possible increase in the gift tax rate that might apply retroactively this year or take effect next year, those wishing to make such gifts can work with an attorney to structure a conditional gift that is designed to become effective at the most favorable time.

Some popular estate planning vehicles also are likely to become less advantageous next year, making 2010 a good time to take action. For example, legislation currently making its way through Congress would change the rules governing grantor retained annuity trusts (GRATs). GRATs are a common estate planning technique used to shift future appreciation of property to others with minimal gift tax cost.

In a GRAT, the grantor transfers assets to a trust, which in turn pays the grantor an annuity for a term of years. The GRAT may be structured to generate minimal or possibly even no gift tax upon creation. If the assets in the trust appreciate enough, money will remain in the GRAT after the last annuity payment is made. Those funds then can pass to the remaindermen free of any transfer tax.

In recent years, creative planners have favored using a series of short-term GRATs for implementing long-term strategies, thus creating opportunities for mid-course adjustments and shifts in strategy. If current legislation is approved, all GRATs would have a minimum term of 10 years. Moreover, GRATs no longer could be set up in a way that leaves the donor with a remaining interest of zero or less when the trust terminates. Until the law actually changes, however, people can take advantage of these techniques, which are expected to be grandfathered under the existing law.

### Thinking Differently About Investments

Rising taxes will likely hit investors on multiple fronts. For one thing, taxes on both capital gains and qualified dividends are expected to rise. Unless Congress takes action, the capital gains tax in 2011 will increase to a top rate of 20% from the current 15%. Moreover, qualified dividends, now also taxed at 15%, would be taxed as regular income at rates that could be as high as 39.6%. Exhibit C, on the following page, compares the changing rates on various taxes, assuming Congress does not intervene. Even if Congress does approve new legislation, President Obama has made it clear he wants to increase capital gains and qualified dividend rates for high-income taxpayers to 20%.

# Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

Also, the brand new Medicare tax has been approved as part of the recent health care overhaul. Beginning in 2013, certain high-income employees will have to pay an additional 0.9% Medicare tax on income while high-income investors will pay a 3.8% Medicare tax on net investment income, which includes capital gains. These apply to taxpayers earning more than \$125,000 (married, filing singly), \$200,000 (filing singly) or \$250,000 (married, filing jointly).

Such increases would have a dramatic effect on an investor's bottom line. Consider Exhibit D, which illustrates the difference in after-tax returns between an investment portfolio taxed under current law and one subject to the rules that existed before the Bush tax cuts. Based on our capital market assumptions, a portfolio of 60% equities and 40% taxable fixed income is expected to produce an annual pre-tax return of 7.7%. Apply current taxes, assuming income tax rates of 35% federal and 5.3% state, and the return would drop to 6.24%. This same portfolio, however, would have an after-tax return of just 5.75% under tax laws that will be in effect when the Bush tax cuts expire at the end of this year. After just 10 years, that 49 basis point difference in return per year would result in more than \$400,000 in lost assets on an initial portfolio of \$5 million.

Exhibit C

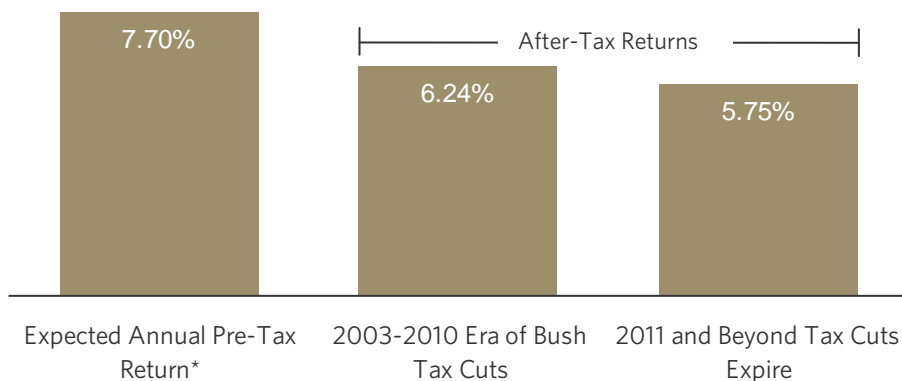
## Changing Tax Rates: 2010-2013<sup>1</sup>

	2010	2011	2013
Ordinary income	35%	39.6%	39.6%
Long-term capital gain	15%	20%	20%
Qualified dividend	15%	39.6%	39.6%
Medicare tax on net investment income (above threshold) <sup>2</sup>			3.8%
Medicare tax on wages - employee	1.45%	1.45%	1.45%
Medicare tax on wages - employer	1.45%	1.45%	1.45%
Medicare tax on wages (above threshold) - employee <sup>3</sup>			0.9%
Social Security tax on wages (up to \$106,800 2010)	6.2%	6.2%	6.2%

<sup>1</sup>Highest income tax rate, <sup>2</sup>Tax is assessed on the lesser of net investment income or the excess of MAGI over the threshold amount, <sup>3</sup>Based on current legislation threshold amounts: \$200,000 (filing single); \$250,000 (married, filing jointly)

Exhibit D

## Impact of Income Tax Rates in Portfolio Return



\*Based on BNY Mellon Wealth Management capital market assumptions

# Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

Given such an impact, investors may want to review their investment strategies. In recent years, some investors may have turned to dividend-producing equities or American Depository Receipts (ADRs) — whose dividends also qualify for the 15% tax treatment. Those strategies, however, will look less advantageous once tax rates rise, particularly for those in the upper tax brackets.

In this environment, investors will want to take advantage of high capital-appreciation strategies that would diminish the impact of the higher income tax rates expected next year by taking advantage of a capital gains rate that is expected to increase to a still favorable 20%. Such a strategy might include small cap stocks and private equity investments. Investors, however, will need to be selective about the kinds of equity investments they choose. Higher taxes likely will act as a damper on economic growth, making it more difficult to find companies that will perform well in a higher tax, slower growth economy.

## What About Fixed Income?

With upper bracket income tax rates expected to hit 39.6%, tax-free investing will look increasingly attractive. But market conditions may limit the appeal of tax-exempt municipal bonds, at least in the short term. For one thing, the number of tax-exempt bond issues has declined significantly since April 2009, when the federally subsidized Build America Bonds made their appearance. Interest paid on these bonds generally is higher than that on traditional municipal bonds, but it is not tax exempt.

Issuers like these bonds because Uncle Sam picks up 35% of the cost of the interest. The result has been that fewer state and local governments are issuing traditional tax-exempt bonds, and the resulting reduced supply is keeping prices high and yields low.

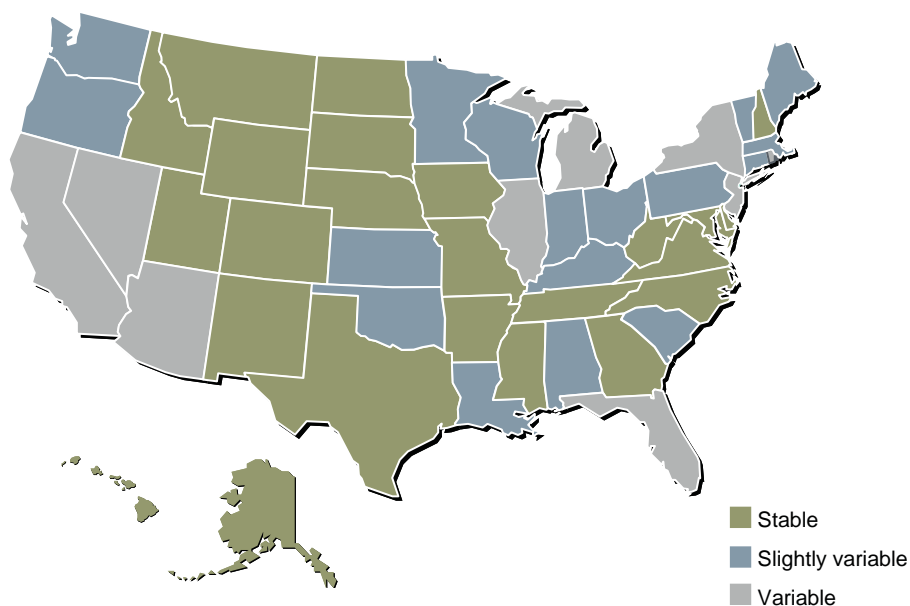
With more taxable municipal bonds being issued than ever before and a diminished supply of tax-exempt municipal bonds, tax-exempts could become even more scarce. In such an environment, tax credit bonds might offer a favorable, tax-efficient alternative. However, these tax credit bonds are very rare, the market for them has not developed, and their future is doubtful.

Credit concerns are another important factor. Investors in high-tax states, such as California and New York, often buy issues from their state of residence in order to avoid both federal and state income taxes. However, as Exhibit E illustrates, that tax-free status now comes with increased risk. Take California, which is the largest issuer of such tax-supported debt. Currently facing a \$20 billion budget gap, the state now has the lowest rating of all 50 states.

### Exhibit E

## Budget Deficits: Impact on Municipal Bonds

### State General Obligation Credit Quality Outlook



Source: BNY Mellon Wealth Management

# Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

Even if the investor must give up the benefits of double tax-exemption, some diversification is in order. Choosing from among the best of the intrastate bond issues is critical, as is looking for quality bonds from other states and other income-producing securities. Then, too, buy-and-hold fixed income investing may be less attractive in coming years, as it would prevent investors from harvesting losses to offset gains elsewhere in their portfolios. Wash sale rules are a minor factor in this market, given the ease of replacing one AAA-rated fixed income security with another AAA security.

## Timing is Everything

In this era of rising taxes, timing and active, tax-conscious portfolio management will be increasingly critical.

Investors, for example, will want to make sure that any gains on their investments qualify for long-term tax treatment, which applies to any security held for more than one year. Otherwise those gains will be taxed as ordinary income at rates of up to 39.6% next year.

At the same time, investors will want to maximize the use of losses to offset gains and thus minimize taxes. Many investors now are sitting on large losses as a result of the 2008 financial market collapse. Some sold securities at a loss, while others still are holding securities that have yet to rebound. A thorough analysis of realized and unrealized gains and losses can be the basis for creating a more tax-efficient portfolio. As an alternative to managing individual gains and losses, investors may want to explore ways to minimize taxes by employing portfolio strategies that help ensure appropriate asset location and tax loss harvesting.

Whatever the strategy, investors and their tax advisors must closely coordinate portfolio management and investment decisions in order to take full advantage of opportunities to reduce taxes.

## Making the Best Use of Retirement Plans

Rising taxes also are a good reason for investors to take care in choosing the kind of assets they tuck into their qualified retirement plans. Once rates rise, a maximum capital gains rate of 20% still will look favorable. In certain situations, investors may consider shifting equity investments into their taxable accounts, while putting income investments, such as taxable bonds and dividend-producing securities, into retirement accounts where they can grow tax free until withdrawn. Exhibit F shows how investors might consider locating assets based on this approach.

*Exhibit F*

### Asset Location

Finding the Optimal Balance

Best to IRAs	Best to Taxable Accounts	Best to IRAs
TAXABLE FIXED INCOME (e.g., corporate bonds, high yield bonds, short-term bonds)	TAX-EFFICIENT EQUITIES (e.g., large cap tax-efficient equities)	TAX-INEFFICIENT EQUITIES (e.g., REITs, hedge funds, actively traded equities, small cap, emerging markets)

## Taxes, Taxes, Taxes: What You Should Know for 2010 and Beyond

This also may be a good time for folks with traditional individual retirement accounts to consider converting at least some of their IRA holdings to a Roth IRA. Why convert? For one thing, income limits on conversions have disappeared entirely, making them available to everyone regardless of their income bracket.

Roths also have some long-term tax advantages over traditional IRAs. Both types of accounts allow money to grow tax-free. When it is time to make withdrawals, money taken from traditional IRAs — which are generally funded with pre-tax dollars — is taxed as regular income. Conversely, withdrawals from Roths, which are funded with after-tax dollars, generally are free from both income tax and minimum distribution requirements, although with some restrictions. This difference can translate into surprisingly large tax savings over the life of a retirement account.

A Roth conversion, however, does come with a price tag. All assets moved from a traditional IRA to a Roth will be taxed as regular income, which can translate into a big tax bill. With income tax rates scheduled to head upwards, however, the timing may not get any better for people who expect to live long enough to recoup on that initial tax bill.

### **Conclusion: Seeing the Big Picture**

Faced with the reality of higher taxes, investors likely will embrace once again the old maxim, “It’s not what you make, it’s what you keep.” With this in mind, tax-conscious investors will rethink their strategies, adjust their portfolios, and pay greater attention to timing. Although gridlock in Washington makes the details uncertain, the future is clear enough for taxpayers and their advisors to start looking ahead. Those who start now will have the time they need to build an effective tax-planning toolbox so that they are ready when higher taxes actually do arrive.

*The information presented herein is intended for informational purposes and convenient reference only. It is based upon information obtained from various sources believed to be reliable, but BNY Mellon makes no representations, whether express or implied, as to its accuracy or completeness. The information presented herein is not intended to provide tax, investment or other advice. Recipients are advised to consult with their tax, financial, investment or legal advisors.*