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Taking Advantage of Favorable Tax Rates Before They Expire

As the final quarter of 2010 begins, it is a good time to review what lies ahead and plan accordingly. 2010 has definitely been full of uncertainties and surprises in many ways. U.S. stock market finished its best September in 72 years, following a sorry August. Gold continues to march towards new record highs in nominal terms while the yield on Treasuries hovers at an anemic level not seen for decades. Aside from the market, we are faced with unknowns in the political sphere as well.

Many other issues that impact our daily lives in a much more direct way have yet to be clarified. For example, a number of Bush tax cuts, which many Democrats now favor extending, are set to expire in 2011, including the 15% long-term capital gains and qualified dividend tax. Both of these have played a significant role in portfolio investment strategies. If Congress, which is now in recess for the mid-term election, does not respond in a way that is perceived positively by the general public, this may trigger corresponding market activity.

Is there a way to take advantage of these general tax cuts before they are gone for good?

The answer is YES! For most people, the 15% tax rates on capital gains and qualified dividends have been a generous "gift" from the government, especially if you are in the higher tax brackets. But what if you could lower the rate to zero, how would that sound? Good, huh? Unfortunately 2010 may be the last year you are able to do so. Although a zero-percent rate only applies to taxpayers in the lowest two tax brackets—10% and 15% (see figure) - it should not stop you from considering using these tax-saving strategies: Realizing gains and gifting.

2010 Federal Income Tax Bracket

Tax Rate	Single Filers	Married filing jointly or qualifying widow/widower	Married filing separately	Head of household
10 %	Up to $8,375	Up to $16,750	Up to $8,375	Up to $11,950
15 %	$8,376 - $34,000	$16,751 - $68,000	$8,376 - $34,000	$11,951 - $45,550
25 %	$34,001 - $82,400	$68,001 - $137,300	$37,001 - $68,650	$45,551 - $117,650
28 %	$82,401 - $171,850	$137,301 - $209,250	$68,651 - $104,625	$117,651 - $190,550
33 %	$171,851 - $373,650	$209,251 - $373,650	$104,626 - $186,825	$190,551 - $373,650
35 %	$373,651 or more	$373,651 or more	$186,826 or more	$373,651 or more

Source: IRS

Realize Gains

First, if your projected 2010 income happens to be in the 10% or 15% brackets, i.e. up to $68,000 for married couples filing jointly, and you have unrealized long-term capital gains in your investment portfolios, you should take advantage by realizing enough gains without putting yourself in the 25% tax bracket or higher. The beauty is that you will bag all of the capital gains but will not have to share a dime

with Uncle Sam. For example, a couple making $50,000 in 2010 is in the 15% bracket. They have a portfolio of stocks worth $98,000, with a cost basis of $80,000. Theoretically, they should liquidate the portfolio and pocket the entire gain of $18,000, but, because $68,000 ($50,000 + $18,000) still falls in the 15% bracket, the $18,000 capital gains will not be taxed at the federal level—you get the 100% gain!

Gifting

Even if you are subject to one of the higher rates, you can still help loved ones benefit from the tax cuts through gifts. Say that your son's household income is $50,000. You, however, have sizable long-term gains in your investment portfolio that, if you realized them, would create a large tax liability. By gifting $13,000 worth (or $26,000 to both your son and his wife or $52,000 if your spouse agrees to gift splitting) of your appreciated stocks, your son (and his wife) can sell the stocks, realize the gain but owe no tax. You may expand that further when children, children-in-law, grandchildren, nieces and nephews, etc. are considered, as long as they are eligible for the 0% capital gains tax treatment. Of course, each person's tax situation is unique and could get complex easily, so be sure to consult your CPA or tax preparer about your concerns.

Another advantage of gifting appreciated investment assets is that, if you have a sizable estate, it can lower your potential estate tax liability. Beginning in 2011, the definition of "sizable" will shrink dramatically. Estate tax, repealed in 2010 but returning in 2011, will come with a much lower exemption amount ($1 million) and a higher tax rate. That means if your estate exceeds $1 million, you will lose 55 cents (which could be saved and passed on) of every dollar above the $1 million exemption (again, unless Congress does something about it). By gifting $13,000—within the annual exclusion amount so no gift tax return is required—to each of your loved ones, you are doing yourself and heirs a favor by reducing the amount that the government can claim.

As we begin the new year with a new Congress, it is a great time to sit down with your advisors to review the estate plans you have in place. If these tax cuts get extended, great. If not, there are various tax-savings strategies and estate planning tools that can provide significant benefits. Please give us a call if you would like to discuss these strategies in more detail.

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