

# Recent Tax Legislation

*A boon for the wealthy?*

## Topical Education for Today's Investor

## INCOME TAXES

Legislation enacted between 2001 and 2006 provided Americans with tax cuts that impacted many areas of their financial lives. While these new laws affect taxpayers facing many different circumstances, they have special implications for high-net-worth individuals.



Keep in mind that many provisions change over time and, due to so-called “sunset provisions,” some of the rules will phase out after 2010, unless Congress renews or changes them. For these reasons, it's important to consult a financial or tax advisor to understand how various elements of the tax laws could affect your personal situation.

### Top Income Tax Rates Coming Down

Effective July 1, 2001, federal income tax rates were reduced as indicated in the table below:

Income Tax Rates	
Old Rates	New Rates
38.6%	35%
35%	33%
30%	28%
27%	25%

### Alternative Minimum Tax

Of equal concern for many affluent individuals is the Alternative Minimum Tax (AMT). The AMT was created by Congress to ensure that there is a floor on the tax liability wealthy taxpayers can realize through the use of credits, deductions, and various strategies. As a growing number of Americans have discovered, taxpayers who would face higher tax liabilities using the AMT than regular income tax rates must use the AMT.

New tax legislation provided a degree of AMT relief. Effective in 2003, the AMT exemption increased from \$35,750 to \$40,250 for single taxpayers and from \$49,000 to \$58,000 for married filers. In 2007, the exemptions were raised to \$44,350 for single taxpayers, and \$66,250 for married filers. However, exemptions will decrease for the 2008 tax year unless Congress elects to increase them, as they have done the last few years.

### Dividends and Capital Gains

Taxes on dividend income paid by U.S. and some qualified foreign corporations have been reduced to 15%. Previously, dividend income was taxed as ordinary income, with rates running as high as 38.6%.

The new rate is scheduled to expire after December 31, 2010. If it expires as scheduled, dividends will again be subject to prevailing income tax rates. Be aware that some types of dividend income — including dividends received from real estate investment trusts — are not subject to the new rate.

In addition, the top tax rate on long-term capital gains (gains on assets held more than one year) has been reduced from 20% to 15%. The 15% rate applies to gains realized after May 5, 2003, and is scheduled to expire after December 31, 2010.

### Estate Planning

There are a number of other tax changes that may impact your estate plan. The federal estate tax exemption was increased to \$2.0 million for 2006 through 2008, and the federal estate and gift tax rates were reduced as indicated in the table. You may now gift up to \$12,000 annually to a single beneficiary — \$24,000 if your spouse joins in the gift — without incurring a gift tax liability. Also, the lifetime gift tax exemption is \$1 million. There are additional new rules to be aware of, including the following.

- **Generation-Skipping Transfer Tax** – If you plan to bequeath assets to grandchildren or others who are more than one generation removed from you, the amount of the generation-skipping transfer (GST) tax exemption will equal the federal estate tax exemption through 2009. After 2009, the GST tax is scheduled to be repealed, and then reinstated in 2011 at a 55% rate.

- **Valuing Assets: “Stepped-Up” vs. Carryover Basis** – The Act will change how heirs determine the cost basis of assets — including stocks, bonds, mutual funds, collectibles, and real estate — that they inherit in 2010 or later. Currently, the cost basis of an inherited asset is “stepped up” from the decedent’s purchase price to the asset’s fair market value at the time of death, or six months later if the heirs designate an alternative valuation date. If the asset subsequently changes in value prior to an heir selling it, the heir’s gain or loss consists of the difference between the “stepped-up” value and the sale price. Beginning in 2010, when heirs value inherited assets, they will be required to “carry over” the decedent’s cost basis. If heirs subsequently sell an asset, they will be required

### Estate and Gift Tax Exemption and Rates

Tax Years	Estate Tax Applicable Exclusion Amount	Highest Estate and Gift Tax Rates
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	Estate taxes repealed	Maximum gift tax rate will be top individual income tax rate (35%)

to pay income taxes based on the difference between the decedent's cost basis and the heir's sale price. To partially compensate heirs for the repeal of the stepped-up basis rule, nonspouses will be permitted to add up to \$1.3 million to the cost basis of their inherited assets, and spouses will be able to add an additional \$3 million — or up to \$4.3 million — to their cost basis before computing taxes on the sale of their inherited assets.

### Retirement Incentives

Tax laws now make it advantageous for a business consisting only of owners and their spouses (if applicable) to start a 401(k) plan. For 2007, the total maximum contribution to a solo 401(k) is \$44,000 (if your compensation level allows), of which \$15,500 may be salary deferral. In addition, you may make a maximum deductible employer contribution of 25% of eligible compensation (\$220,000 compensation cap, subject to cost-of-living adjustments). If you will attain age 50 during 2007, you may make an additional catch-up contribution of \$5,000.

Solo 401(k) plans offer higher contribution limits than SIMPLE, SEP, Profit Sharing, and Money Purchase Plans. Keep in mind, however, that if your business plans to hire employees in the future, a solo 401(k) plan may not be your best choice.

### Investing for Education

If education expenses are part of your family's future, recent changes in tax laws may enhance the appeal of certain college savings vehicles.

Many state-sponsored 529 plans permit balances to grow to amounts in excess of \$200,000 before capping contributions. For this reason, these college

savings plans may be excellent investment vehicles if your family anticipates higher-education expenses. Distributions from 529 plans are now tax free as long as the money is used to pay for qualified higher-education costs. Previously, withdrawals were taxed at the student's tax rate. Also, you may now transfer assets from one 529 plan to another without paying a tax on the transfer, as long as the new plan is established for the same beneficiary. However, only one transfer in any 12-month period is permitted.

Contributions to 529 plans may potentially reduce the size of your taxable estate. For tax purposes, a contribution is considered a gift from the account owner to the beneficiary. An account owner may, therefore, contribute up to \$12,000 per beneficiary annually — up to \$24,000 if a spouse joins in the gift — without incurring a gift tax liability. If you want to reduce the size of your taxable estate more quickly, you may make five years' worth of gifts in a single year — \$60,000 or \$120,000 if done with a spouse — as long as you do not make additional gifts to the beneficiary during the subsequent five years. A gift tax return must be filed if you want to count the gift as made over five years. Keep in mind that a prorated portion of the contribution may be considered part of your estate if you do not outlive the five-year period.

### Putting It All Together

Tax laws contain myriad details, so be sure to consult a financial advisor or tax professional to determine how they apply to your situation. Also, keep in mind that the sunset provisions will take effect at various points prior to 2011, and Congress may change the laws at any time. Your short- and long-term financial planning may need to account for some contingencies, but an understanding of the issues mentioned in this article may give you a good start.

## Points to Remember

1. Tax rates on ordinary income, dividends, and capital gains have decreased while the exemptions for taxpayers who pay the alternative minimum tax have increased.
2. Estate planning will be affected as a result of declines in the maximum estate and gift tax rates, increases in the estate tax exemption, repeal of the estate tax in 2010, a higher lifetime gift tax exemption, and other provisions.
3. Qualified withdrawals from 529 plans are not currently taxed, and investors have more latitude to transfer assets from one 529 plan to another for the same beneficiary. In addition, 529 plans contain many estate planning benefits that may appeal to high-net-worth investors.
4. There are additional tax laws that pertain to employer-sponsored retirement plans, individual retirement accounts, the child tax credit, marriage penalty relief, and other issues that impact many Americans.

**For more information, please contact your financial advisor.**

## Important Additional Notes

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