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2010 Tax Act: Now's the Time to Step Up Income and Multiply Estate Values

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On December 17th, 2010, the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 ("**2010 Tax Act**") was enacted. The two-year tax window provided by this bill offers more than income tax relief. It will enable many high net worth clients to dramatically increase the estate they pass on to future generations – provided they take action before the tax window slams shut.

As most of you know, **now is the time to take action**. But getting clients to think about these opportunities can sometimes be difficult. We have already discussed this with many clients and encouraged them to work with their trust and estate attorneys and other advisors to implement a plan.

Tax rates are almost certain to go up in 2013

The primary income tax provisions contained in the 2010 Tax Act are a two-year extension of the 35% maximum individual income tax rate and the 15% long-term capital gain and qualified dividend tax rate. In addition, a limited IRA charitable rollover was extended through the end of 2011.

By historic standards, a 35% top federal tax bracket is quite low. In fact, we know that tax rates will go up in 2013 for certain high income taxpayers as a result of the 3.8% additional Medicare tax that will be imposed on investment income topping certain thresholds starting that year. In addition, we know that if there is no congressional action between now and then, the top bracket will revert to the 39.6% rate that was in effect prior to the Bush tax cuts.

As a result of these two changes, top income earners could see their top income tax bracket increase by 24%, from 35% to 43.4% starting in 2013. Of course, Congress could take action to change this between now and then, but we can't count on it,



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particularly with so much pressure to reduce the deficit. This tends to suggest that, in the right situations, accelerating income by methods such as Roth IRA conversions could make good sense.

Gift, estate and GST exemptions can have enormous impact

The real buzz is around the Tax Act's increase in the gift, estate, and Generation Skipping Transfer (GST) exemptions to \$5 million (\$10 million for married couples) for 2011 and 2012, with a 35% top tax rate above these. Notable by its absence was any minimum term or other restriction on Grantor Retained Annuity Trusts (GRATs), which are a known target of the Obama Administration.

The ability for an individual to move \$5 million to the next generation - without any transfer taxes - is very powerful, since this also shifts any future growth out of the estate. A married couple could transfer \$10 million to their grandchildren without any gift or GST tax implications.

How gifting \$10 million today could = a \$60 million estate in 15 years

If our couple's \$10 million gift tripled by the time they die in 15 years (which would just take an 8% annual rate of return), their estate would have \$30 million available for their grandchildren - free of any transfer taxes. If they had done no gifting, \$30 million would still be in their estate, but subject to estate and GST taxes. By the time the IRS finished collecting, our couple's grandchildren would inherit just \$18.5 million.¹

Viewed from another perspective, with no gifting, our couple's estate would need to grow to \$60 million by the end of 15 years in order for the grandchildren to receive \$30 million. Turning \$10 million into \$60 million in 15 years through portfolio gains alone would be a tall order indeed!

And there are still more opportunities for minimizing one's taxable estate. The \$5 million/\$10 million gift exemption amounts can be further leveraged through discounts, low cost loans, or the use of GRATs, to name but a few strategies.

¹This assumes current \$5m exemptions and 35% maximum tax rates are in effect at the time of the second grandparent's death. It also assumes the grandparents die in a jurisdiction without a state estate tax. It would of course be bleaker if there were a state estate tax or rates reverted to higher rates.



We work with our clients' accountants, estate planning attorneys and other advisors to ensure a holistic, collaborative approach that considers all aspects of their financial lives.

Lifetime gifting is not a panacea

In spite of the huge benefits to lifetime gifting, it may not make sense for everyone to take advantage of the current favorable transfer tax environment. For instance, regardless of the estate tax benefits, you probably should not transfer wealth to the next generation if there is a risk that you will run out of money during your own lifetime. The younger you are, the greater this risk. And, if you intend to leave your entire estate to charity, there would be no estate tax anyway; hence no reason to take advantage of the current favorable transfer tax rules.

The Tax Act's advantages are temporary – and likely to go away

The temporary nature of the Act's provisions as well as the Obama administration's stance on the GRAT vehicle, highlight the increasing need to be aware of current tax developments for planning opportunities. At Federal Street, we are strongly encouraging our clients to evaluate the advantages and disadvantages of lifetime gifting – as well as opportunities to increase their income while tax rates are low.

At Federal Street Advisors, we serve as the family office for many of our clients – which means that we work collaboratively with their accountants, estate planning attorneys and other advisors to ensure a big-picture approach that considers all aspects of their financial lives.

Ultimately, our success lies not just in optimizing our clients' portfolios, but in helping them meet their overall financial, estate and philanthropic objectives.

Please visit [our website](http://www.federalstreet.com) to learn more about Federal Street Advisors' expertise, philosophy, services and staff.