MARKET STREET OVERVIEW | DECEMBER 2011

TAX UPDATE

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INTRODUCTION

The deficit crisis and a sagging global economy have resulted in another year of uncertainty with respect to taxes. While there has been a lot of talk about what could happen and what needs to happen with legislation, very little has actually changed. As you may have discussed with your Wealth Advisor and Tax Preparer, opportunities still exist to minimize taxes. Market Street is in the process of wrapping up year-end tax planning for our clients and we have thoughts that warrant mention.

INCOME TAX PLANNING

Charitable contributions for the philanthropically inclined are an option to aid in tax minimization. Contributions to certain tax exempt organizations can be deducted up to 50% of your adjusted gross income with any excess carried forward to benefit your subsequent tax years. In order to take the deduction for 2011, the contributions must be paid by December 31, 2011.

Donation of low basis public stock is another tax efficient way to make charitable contributions since the donor receives a charitable deduction for the full fair market value of the stock. Since the stock is not sold, no capital gains are incurred. If you have questions, please contact your Wealth Advisor.

"Contributions to certain tax exempt organizations can be deducted up to 50%"

ESTATE TAX LEGISLATION UPDATE

A linked set of taxes on estates, gifts and generation skipping transfers, commonly referred to as "Transfer Taxes," have been used by the federal government to raise revenue since the late 18th century. Historically, these taxes have constituted a small portion of total federal revenues. However, due to current budget deficits, legislators are now looking at all taxes as a way to bring in more revenue. While originally designed as a unified system, prior to 2011, gift tax exemptions have not kept pace with the estate tax exemption and the generation skipping transfer (GST) tax exemption. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reunified the estate tax exclusion with the gift tax exclusion so that both exclusions are the same. In addition to unifying the exemptions, the exemption amounts increased to $5 million with a top tax rate of 35% through 2012.

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The GST exclusion has also risen to $5 million per person. For the first time in many years, clients will be able to fund a GST trust for the benefit of grandchildren and subsequent generations up to $10 million per couple without paying gift tax on the transfer. For example, a husband and wife could fund a GST trust with $10 million in 2011. Assuming a 6% growth rate and that the donors die in 30 years, the trust will grow to $60.9 million with no estate or gift taxes paid when this amount is transferred to descendents. If the money had been left in their estates and passed to the descendants at the time of their deaths, the descendants would inherit only $31.5 million, and $29.4 million would be paid in transfer taxes.

The opportunities presented with the reunification of these taxes could be short lived. Without Congressional action, the current exclusions will revert to $1 million, and the top estate tax rate will revert to 55% in 2013. (Note: There has been discussion that in an effort to balance the budget, the current gift tax rates and exclusions might end as early as December 31, 2011 instead of December 31, 2012.) The equalization of the exclusion amounts (estate, gift and GST) presents a tremendous opportunity to move substantial resources outside of your estate, tax free, to grow and supplement the needs of your children, grandchildren and subsequent generations for many years to come.

OTHER WEALTH TRANSFER STRATEGIES

In addition, there are other types of wealth transfer strategies you may wish to consider.

Annual Exclusion Gifts:

Annual Exclusion Gifts can be made every year up to an inflation adjusted amount, currently $13,000 per individual, each year ($26,000 per individual each year if you elect to gift-split with a spouse) without impacting your lifetime exemption. Additionally, there is an unlimited exclusion for direct payments of educational or medical expenses as long as certain rules are followed. This can be a powerful tool in wealth transfer planning.

Also note, any gifts in excess of the annual exclusion amount are gift tax free to the extent the gifts are below the lifetime maximum of $5 million (through December 31, 2012 under the current tax code). After that level, the current tax rate is 35%.

Grantor Retained Annuity Trusts:

A Grantor Retained Annuity Trust (GRAT) is a trust established and funded with assets by the grantor which pays a series of annuities to the grantor over the GRAT's term. If the assets appreciate above the applicable federal rate (AFR) and the grantor survives the term of the GRAT, the appreciation passes to the remainder beneficiaries (usually children), gift-tax free. The annuity payments are determined by the applicable federal rate. Rates are at historic lows; the December 2011 AFR is 1.6%.

The following is an example of how a GRAT might work: assuming a 6% annual return, a two year GRAT funded with $3 million in November 2011 would result in a tax-free transfer of $215,807 to the beneficiaries upon the GRAT's termination.

It should be noted that there has been ongoing discussion of legislative changes to GRAT rules, including requiring a minimum term of ten years for a GRAT, which would limit the tax benefits of this wealth transfer strategy.

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OUTLOOK

Barring legislative action, gift, estate and GST tax exemptions will decrease to $1 million and transfer tax rates will return to pre-Bush era rates beginning in 2013. Note that there has been discussion that instead of all exemptions reverting back to $1 million, perhaps the estate and GST exemptions would go down to $3.5 million. However, there have been discussions that the gift tax exemption would still revert to $1 million. Either way, it seems likely that the current environment will soon give way to a much less favorable transfer tax situation. Based on available information, we encourage you to act quickly. Please note that the ideas presented in this newsletter may not be appropriate for each client's situation. If you are interested in discussing or pursuing these or other wealth transfer strategies, please contact your Wealth Advisor.