

Preparing Your Wealth for Coming Tax Changes

WHEN MOST PEOPLE THINK of their hard-earned wealth and how to protect it, they usually think in terms of grand concepts such as life insurance, trusts and conservative investments. But there is another overlooked subject that, if not addressed, can silently erode the value of many portfolios. ¶ That subject is taxes, which can affect what you'll end up with at retirement or when the time comes to transfer your estate to the next generation. Think of it this way: taxes on a portfolio are similar to a hole in the bottom of a bucket. Many investors do a great job of filling their buckets with wealth only to lose a meaningful portion to Uncle Sam. The problem is even more pronounced for higher income investors and will only get worse as the temporary tax breaks enjoyed under the Bush administration are scheduled to end later this year. Capital gains taxes, which are currently as low as they've been in recent memory, will spike up to 20 percent on most assets held for over a year starting in 2011.

Also starting next year, income taxes will jump in most brackets, and the highest earning Americans will see their income tax rate rise to 39.6 percent, which represents a nearly one seventh increase over today's top bracket of 35 percent. In 2011, the amount you can transfer tax-free to your heirs is scheduled to drop back to \$1 million from the current unlimited amount under the federal laws (source: Tax Policy Center, 2010).

All of these changes are coming soon, and smart investors are taking steps now to manage their wealth around them.

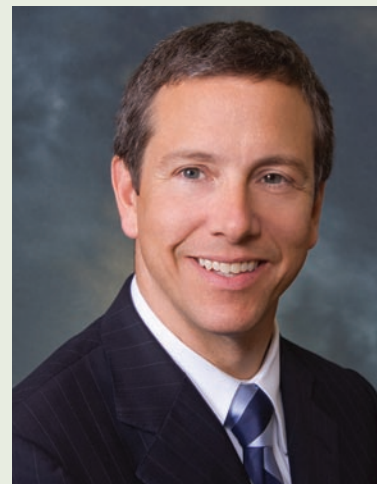
One couple's situation

Take the hypothetical case of Laura and Jack, who are both physicians. They met back in medical school, and when they started saving for the future, they weren't concerned with taxes since they didn't earn very much and had a mountain of medical school debt. (They were so busy working that their investments were cobbled together without much thought about taxes in the first place.) Currently in their late forties, they both earn well into the six figures and are in the highest income tax bracket. They've managed to

amass significant net worth, but are concerned that they've been paying taxes unnecessarily on their investments. Now they've heard that rates are scheduled to increase, and they're motivated to do something about it.

How they could address it

To mitigate the draining effects of taxes on their portfolio, they have met with their advisor who helped them make a checklist of steps to take. They will hold investments such as taxable bonds and high turnover equity managers – which are more likely to generate a larger tax bill – in their tax deferred accounts (IRAs, Roth IRAs, annuities, and employer retirement accounts). Next, they have chosen tax-advantaged bonds, low turnover equity managers and other tax efficient investments for their joint and individual non tax-sheltered accounts. Laura and Jack plan to use separately managed accounts, in which gains can often be offset by losses with careful tax planning to make them more tax neutral. They have an opportunity to take advantage of this year's special rules and convert a portion or all of their regular IRAs into Roth IRAs. They have also planned



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a meeting with their estate planning attorney to review their documents in light of the coming changes in estate tax laws.

Laura and Jack now have a sound strategy for plugging the tax hole in their wealth bucket. Of course, like them, any investor should check with his or her CPA or qualified tax advisor to determine the tax result of making portfolio changes. Likewise, the suitability of investments themselves and their proper mix within a portfolio will vary from person to person. But considering the coming higher rates, it makes sense – as it has for Laura and Jack – to address the topic now while there's still time to plan for it. U