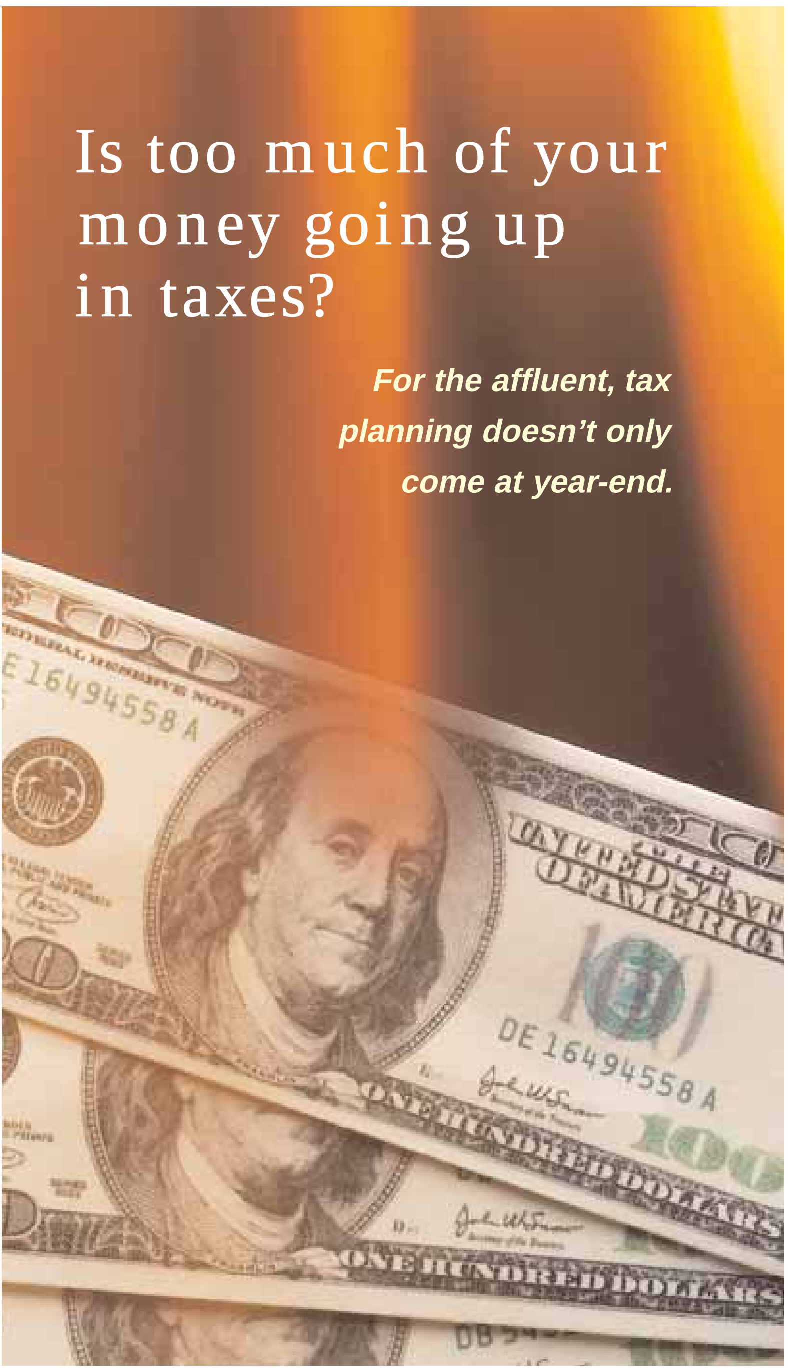
IN THIS ISSUE

April 2007

Is too much of your money going up in taxes?

For the affluent, tax planning doesn't only come at year-end.



There has been some good news lately from Washington, D.C., on the budget front. The deficit has been coming down faster than anyone had predicted. But the better matching of income and expenditures doesn't come from the spending side of the ledger; it's that tax collections have grown at double-digit rates. But you didn't hear that Congress increased rates or closed loopholes, because that didn't happen. Increasing collections are the consequence of the strong economy, growth in profits, and skyrocketing realizations of capital gains. No one knows how long that phenomenon will last.

But those who are paying those larger tax bills may sit up and take notice, and take steps to bring that burden under control.

First steps

The tax code offers a wide array of choices for building capital on a tax-deferred or tax-free basis. These are focused on providing resources for retirement, education and, for some taxpayers, medical expenses. If you are eligible, you may reduce current taxes through an IRA contribution. Otherwise, you can reduce or eliminate future taxes on your savings by maximizing your deferrals to:

- an employer's 401(k) or 403(b) plan;
- a Roth IRA;
- a 529 plan for education savings; or
- a Health Savings Account, if you meet eligibility requirements.

A portion of your taxable portfolio may be dedicated to investments that are generally tax free. (See page 3, "On the tax freedom of munis," for details.) The balance of your portfolio may be managed in a tax-efficient manner.

Tax efficiencies arise when choices are made with the 15% tax rate on long-term capital gains and qualified dividends in mind. (See page 2, "Tax effects of choosing the right shares to sell," for one example.) When the top tax rate on long-term gains was reduced to 15%, some observers expected the average holding period to lengthen as investors strove for better after-tax returns. That has not happened. According to one recent study, the average holding period for stocks on the New York and American Exchanges has shrunk from more than a year in 1999 to just seven months. (The last time the holding period was so short was in 1929.)

Advanced planning

Your individual circumstances will dictate whether any of these strategies might be of benefit.

Serial home sales. Up to $250,000 of gain is tax free upon the sale of a principal residence, or $500,000 for married couples filing jointly. That sounds like a lot, but for those who have owned their homes for a long time, it may not be enough to reduce taxes on the sale to zero.

The full exclusion is available every two years. Some people who have been required to relocate frequently may be able to build a rather nice nest egg along the way.

Like-kind exchanges. When property that is held for productive use in a trade or business is exchanged for property of a "like kind," for use for a similar purpose, no gain or loss is recognized on the exchange. (However, if cash is involved that part of the exchange will be taxed.) The most common form of like-kind exchange is the real estate swap, which may allow a property owner to "trade up" to a larger property on a more tax-efficient basis.

Philanthropy. There are many incentives in the tax code for making charitable gifts. One of the best is the tax treatment of appreciated securities. For example, a person who makes a gift of stock valued at $10,000 to a qualified charity will get a $10,000 tax deduction, even if he or she paid only $1,000 to buy the stock initially. No tax is imposed on the increase in value. (Other restrictions may apply to the deduction, however.)

Capital may be redeployed for private and charitable purposes through a thoughtfully designed trust. The charitable interest may be at the trust's termination, or the income may go to charity and the assets stay in the family. The income, gift and estate tax benefits of charitable trusts can make them an ideal strategy for the philanthropy-minded family.

We have more ideas

Our job as a corporate fiduciary is to develop investment and financial management plans for people in a great range of circumstances. We think creatively; we don't approach our clients with preconceived notions of the best way to achieve their unique goals.

Everyone should explore the options and opportunities presented by our trust and investment services. If you have not done so already, we invite you to contact one of our officers soon to learn more. ☐

PORTFOLIO MANAGEMENT **Tax effects of choosing the right shares to sell**

Selling stock isn't typically a tax-driven decision, but tax consequences do need to be taken into consideration. If you've purchased shares of a company over a number of years and have decided to lighten your holdings, your choice of which lot to sell could make a big difference on your tax bill. Here's a simplified example.

Sam and Janet own 40,000 shares of a hypothetical company we'll call XYZ Corp. They purchased the shares at various times over the past ten years, in four transactions of 10,000 shares each. Here is a summary of their position:

XYZ stock	Held for	Cost/share	Purchase price
Block 1	10 years	$5	$50,000
Block 2	5 years	$10	$100,000
Block 3	3 years	$15	$150,000
Block 4	6 months	$10	$100,000

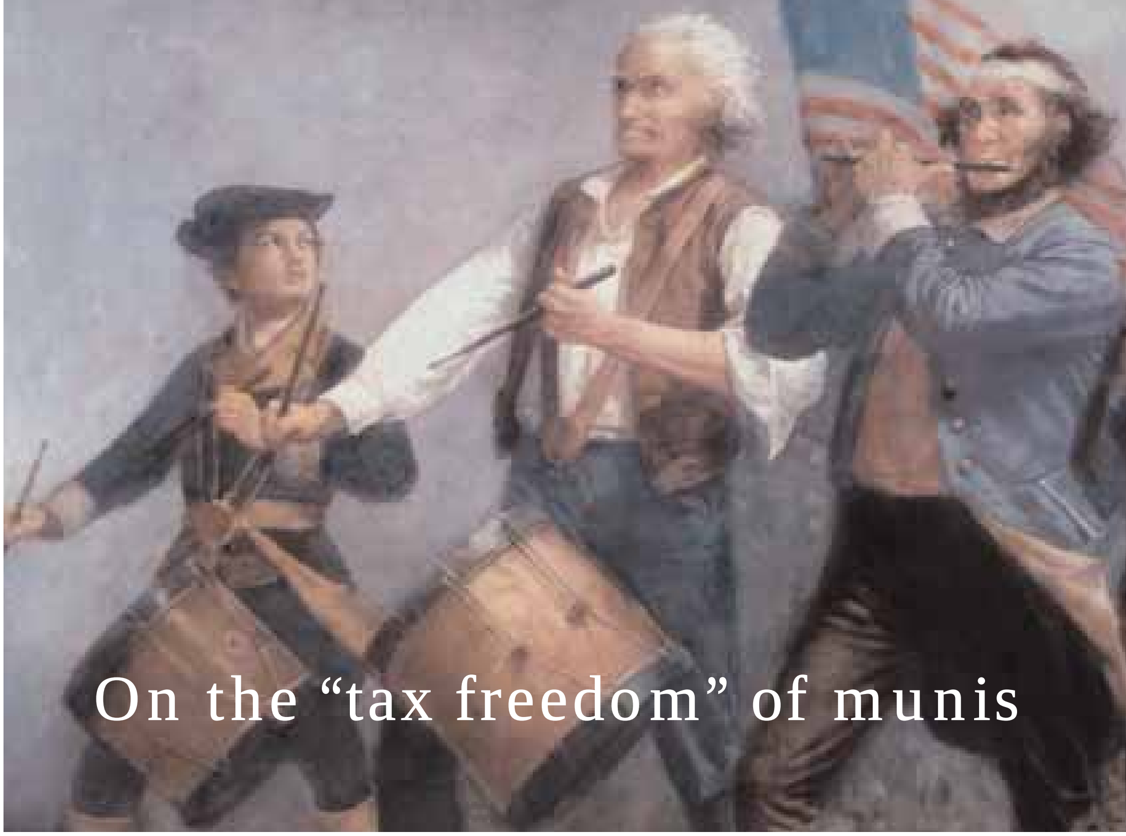
Now let's assume that Sam and Janet need to sell one block of 10,000 shares and the current price is $12 per share. They can have a gain or a loss, depending upon which block they choose to sell, and the gain can be long term or short term. This table summarizes their potential tax liability:

XYZ stock	Gain (loss)	Tax rate	Tax due (tax savings)
Block 1	$70,000	15%	$10,500
Block 2	$20,000	15%	$3,000
Block 3	($30,000)	15%	($4,500)
Block 4	$20,000	35%	$7,000

Should the couple choose to sell Block 3, they will realize a long-term capital loss of $30,000, which may be netted against long-term gains for a potential tax savings of $4,500. The worst result would be first in, first out, selling Block 1 and triggering a large tax bill, but that is the approach required by IRS Regulations if the taxpayer fails to identify the proper lot to be sold.

Tax planning for real portfolios is more complicated than this simplified example. As you can see, excellent records are an essential prerequisite for informed decision making.

On the "tax freedom" of munis



Municipal bonds have long been prominent in the portfolios of high-income persons. Because their interest payments are not normally subject to federal taxation, they provide less pre-tax income than taxable bonds. That also means less interest expense for the states and localities that issue the bonds, and less burden on taxpayers. On an after-tax basis, munis may provide more spendable cash than their taxable counterparts, and they are usually backed by the taxing power of the issuer.

However, there are times when municipal bonds generate direct or indirect tax liabilities.

Taxable moments

Social Security interactions. A portion of one's Social Security benefits may be subject to federal income tax. How big a portion? That depends upon how much "provisional income" one has, and that number includes interest payments from tax-free munis. However, investing in fully taxable bonds would likely boost the taxable portion of Social Security even higher.

Private activity bonds. Municipal bonds that are sold for private purposes, such as stadiums or industrial parks, generate interest payments that are tax free for ordinary income tax calculations but fully taxable for purposes of the Alternative Minimum Tax. As a result, the interest rates on these bonds is generally a bit higher than it is for fully tax-free bonds. If you know that you will be AMT free, it may be worthwhile to seek out these bonds. But you will likely be disappointed by your after-tax returns from these instruments in the years when you do pay the AMT.

Capital gains and losses. If you sell a municipal bond for more than you paid for it, you've generated a fully taxable gain. Fortunately, if you've held the bond for at least 12 months, you'll be eligible for the lower tax rate on long-term gains.

Original issue discounts. If you have purchased municipal bonds after April 30, 1993, at a discount from their face value and later sell for a higher price, a portion of your gain may be taxed as ordinary income.

Estate taxes. The estate tax applies in full to the full fair market value of all municipal bonds held by an estate.

State income tax. The general rule is that for state income tax purposes, the interest payments from in-state bonds are tax free, while the interest from out-of-state bonds is taxable.

A common tax treatment under assault

That practice has now been challenged in Kentucky. In April 2003 Mr. and Mrs. Davis challenged the constitutionality of taxing some muni bonds and not others, pointing to the Commerce Clause of the U.S. Constitution and the Equal Protection Clause of the Fourteenth Amendment. When the trial court granted the government's motion for summary judgment, holding that the bond taxation system passes constitutional muster, the Davises appealed.

The Kentucky Court of Appeals agreed with the taxpayers, based upon past decisions of the U.S. Supreme Court. Back in 1994 the Supreme Court ruled that "it is well established that the [Commerce] Clause also embodies a negative command forbidding the States to discriminate against interstate trade." That case didn't involve bonds, but the Kentucky Court found that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to the in-state bonds than it does to extraterritorially issued bonds."

Recently, Kentucky's Department of Revenue asked the U.S. Supreme Court to review the case, and the taxpayers have filed a brief in opposition. At this writing we do not know whether the case will be accepted for review, though a split among state courts argues in favor of resolving the question. Should the U.S. Supreme Court agree with the Kentucky Court of Appeals, tax refunds for open years may be in order for owners of municipal bonds who have paid state income taxes on their interest.

There is never a dull moment when it comes to portfolio management! ☐

Anna Nicole Smith's likely will controversy

If ever there was an example that demonstrated the need for frequent will review, it is the situation of Vickie Lynn Marshall, a.k.a Anna Nicole Smith. Of course, much notoriety surrounds the case; the cable news shows evidently find it a real ratings booster. For those who are unfamiliar with the basic facts, at the time of her death Vickie Lynn Marshall was engaged in protracted litigation over her inheritance rights from the estate of her deceased billionaire husband, J. Howard Marshall II. She gave birth to a daughter, Dannielynn, in September 2006, and her son, Daniel, died three days later.

The problematic will language

At this writing Vickie Lynn's will, executed in 2001, has not been probated, but reportedly it includes this key language:

> *I am unmarried. I have one child DANIEL WAYNE SMITH. I have no predeceased children nor predeceased children leaving issue. Except as otherwise provided in this Will, I have intentionally omitted to provide for my spouse and other heirs, including future spouses and children and other descendants now living and those hereafter born or adopted, as well as existing and future stepchildren and foster children.*

Dannielynn was born after this will was executed. As such, she would be considered an "afterborn" child, and state statutes may provide inheritance rights for such children. Also, Dannielynn would be the sole heir to the estate unless there is a surviving spouse, a fact that is in dispute at this writing. On the other hand, that "negative gift" that explicitly disinherits any children born or adopted after the execution of the will would appear to bar Dannielynn's claim to the estate.

Was this what Vickie Lynn wanted? Almost certainly not; reportedly before Vickie Lynn died, she had an image of Dannielynn tattooed on her back. Did she understand the meaning of the quoted paragraph and intend that result? Or was it "boilerplate" that she skipped over because it didn't seem relevant at the time? Courts have gone both ways in situations such as this.

The better course

Before she took time for the tattoo parlor, Vickie Lynn should have arranged a meeting with an estate planner. Both the death of a beneficiary and the birth of a child are occasions that cry out for an estate planning review. But when you are not yet 40 years old, living in the public spotlight, it may seem that you have more than enough time for such mundane matters. ☐