



FALL 2010

FIDUCIARY PERSPECTIVE

INSIGHTS ON PRIVATE WEALTH MANAGEMENT

YEAR-END TAX PLANNING DURING UNCERTAIN TIMES

What should you do about year-end tax planning this year? During most years, as the calendar turns to the last quarter, it is prudent to review your personal financial and tax situation and develop a strategy for the remainder of the year.

Although this year is no different, it is more complicated. With uncertainty around what, if any, legislation will be passed and signed into law before December 31st, year-end planning needs to be flexible.

When Congress reconvenes, there will be a number of possible outcomes. If they fail to pass any legislation, the 2001 tax cuts will expire and taxes will revert to their earlier rates. If Congress simply extends the 2001 tax cuts for one or more years, current tax rates will continue. The third alternative is that Congress passes some type of tax reform legislation, the details of which are not known. Although it is impossible to predict what will happen, you should begin thinking about the planning possibilities.

Income Taxes

Ordinary Income: Currently, under the 2001 tax cuts, the top marginal individual income tax rate is 35%. If the tax cuts expire, the top rate will increase to 39.6%. Even if Congress passes tax reform legislation, there is a movement for the top tax rate to increase to 39.6%. Taxpayers in the top marginal rates should consider accelerating ordinary income into 2010 to take advantage of the current tax rate structure. One opportunity that was discussed in the fall 2009 *Perspective* is to convert all or a portion of your traditional IRA to a Roth IRA. For any conversions made during 2010, you may report the related taxable income this year, or delay the reporting by splitting the income equally between your 2011 and 2012 tax returns. This gives you the unique opportunity to delay the final decision on which tax year you will report the income until at least April 15, 2011.

It may also be beneficial to postpone year-end charitable gifts to early 2011. If higher ordinary income tax rates do apply next year, you may receive a larger tax benefit for the donation in 2011.

Dividend Income: Qualified dividends are currently taxed at a 15% federal rate. If the 2001 tax cuts expire, the top marginal rate on dividends will increase to the 39.6% ordinary income tax rate. Alternatively, some in Washington are proposing to increase the

tax rates from 15% to 20%. Either way, unless Congress extends the 2001 tax cuts, qualified dividend income will be taxed at a higher rate next year.

Capital Gains: Long-term capital gains are currently taxed at a top rate of 15%, rising to 20% if the 2001 tax cuts expire. At 15%, rates are as low as they have been since the mid-1930s. This makes 2010 a particularly attractive year to consider recognizing additional gains. This is especially true if you hold concentrated positions or would benefit from additional diversification. The conventional advice to consider offsetting gains with capital losses is still sound.

Alternative Minimum Tax (AMT): If Congress does not take action, it is expected that the number of taxpayers affected by the AMT will increase dramatically. The AMT essentially disallows deductions taken for amounts paid for local and state income taxes, real estate taxes, and personal exemptions, among other things, and imposes a tax, in most cases at a 28% rate. If you are normally subject to the AMT, you may find that reporting the income from your Roth IRA conversion may lift you out of AMT for 2010. If this is the case, you should consider paying your fourth quarter state estimated tax payment before December 31st.

Gift, Estate and Generation-Skipping Taxes

Gift Taxes: As long as it fits into your overall objectives and financial planning, and regardless of what action Congress takes, you should consider making annual exclusion gifts and paying others' medical and educational expenses. As you may recall, you may make gifts of up to \$13,000 per year to as many individuals as you desire (up to \$26,000 if you are married and split gifts with your spouse). Tuition expenses and qualified medical expenses paid directly to the provider are not considered taxable gifts, and do not count against the \$13,000 annual exclusion gift amount. All of this is in addition to the \$1 million lifetime gift exemption that each individual has. *(continued on page 4)*

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WHERE IN THE WORLD?

Asset allocation for client portfolios is done in a similar way to how a business person might determine where best to invest capital. How favorable are the demographics within a particular market? How quickly is per capita income rising? Where will capital best be treated? Where are the greatest rewards versus the potential risks? Over the past several years, we have become increasingly concerned about returns on invested capital in the U.S., the U.K. and Europe. Slowing economic growth, high levels of debt, rising levels of taxes and regulation all make for a potentially challenging investment environment. Alternatives, such as other overseas markets, are important to consider for improved returns. This may mean holding more assets in emerging markets or non-dollar denominated currencies.

The U.S. Picture Today

The most recent census data gives a discouraging view of our country through the end of 2009. The fraction of Americans living in poverty has risen from 13.2% in 2008 to 14.3% at the end of 2009, the highest level since 1994. Some 43.6 million Americans receive food stamps. The inflation-adjusted median income of Americans fell 4.8% from 2000 to 2009, significantly worse than the challenging 1970s when the median income rose 1.9%. Today our unemployment rate is just under 10%, double what it was at the beginning of 2008. Over 8.5 million jobs have been lost over the past two years. Housing prices, often the anchor of consumers' sense of wealth, have fallen over 30% nationally.

There is some good news. Personal disposable income is up 3% from a year ago. Personal savings levels have risen from 1.0% in July 2005 to 5.9% in July 2010 as consumers reduce indebtedness. The private sector has added 700,000 new jobs since the beginning of the year. This is a drop in the bucket of lost jobs, but it is a start at repairing the recent damage.

In our last *Perspective*, we forecasted that the rate of economic growth enjoyed since March 2009 would slow by the end of this year and that the U.S. GDP growth would fall to 1.5% to 2.0% by the end of 2010. Indeed, both the manufacturing and service sectors have begun to slow and even the second quarter GDP growth has been revised down to 1.7%. After an initial strong recovery due to several measures of monetary and fiscal stimulus, as well as inventory rebuilding, the effects have worn off. We noted that the underlying structural problem of high deficits and a growing ratio of U.S. debt to GDP have begun to slow economic growth. This ratio is currently 90% debt to GDP and is projected to rise over the coming decades. The 90% level is a Rubicon of sorts since it defines the level above which GDP growth is expected to fall to below 2%.

By 2040, it is projected that nearly 25% of our nation's GDP will be consumed by the interest service on our outstanding federal debt. A collaborative study by the Brookings-Heritage Fiscal Seminar, which covers the ideological liberal-conservative spectrum, estimates that we need to raise an additional \$3 trillion in taxes over the next ten years to cover a growing number of federal government expenditures. Today, the U.S. business person is faced with great uncertainty. This was noted in the most recent minutes of the Federal Reserve's policy-making body, the Federal Open Market Committee (FOMC), "a number of participants [at the FOMC meeting] noted that business contacts again indicated that uncertainty about future taxes, regulations, and health-care costs made them reluctant to expand their workforces."

The Alternatives to the Developed Markets

Given that our economy is in a fragile state and that the outlook is not robust, where else can we employ capital for more promising returns? Many of our developed country brethren are faced with similar discouraging futures. We need to examine what the future promises for the less-developed emerging markets.

This concept is not new. Many U.S. companies have worked for years to grow their markets overseas. What is new is the improved state of many countries' financial conditions, including lower rates of inflation and sounder fiscal policies. Legal structures have also been developed to help protect private property. This has meant an improved investment environment for the establishment and growth of businesses.

Not all countries have achieved political stability or full corporate protections. There are risks overseas. China continues to wrestle with intellectual property rights. Russia ran roughshod over both its domestic and foreign investors in its oil industry over the past several years. While emerging markets are increasingly attractive, they also bring with them investor risk.

Exhibit 1: Actual (2009) and Projected Economic Growth Rates

	2009	2010	2011	Next 5 Years
World	-0.8%	3.9%	4.3%	4.4%
United States	-2.5	2.7	2.4	2.1
Euro Area	-3.9	1.0	1.6	2.1
United Kingdom	-4.8	1.9	2.7	2.0
Japan	-5.3	1.7	2.2	1.8
China	8.7	10.0	9.7	9.5
Developed Economies	-3.2	2.1	2.4	2.3
Emerging Economies	2.1	6.0	6.3	6.6

Source: IMF World Economic Outlook

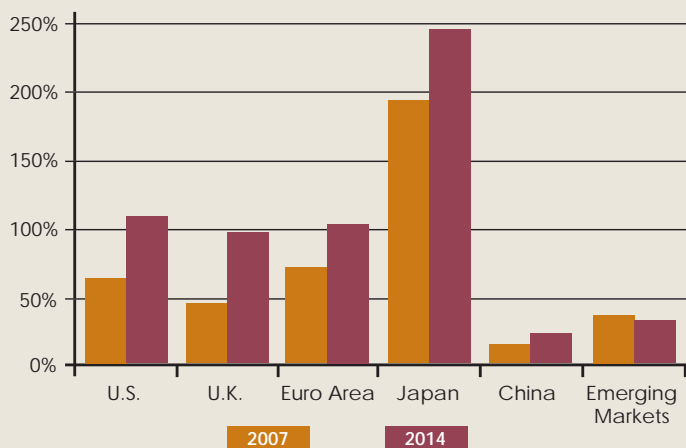


The Argument for the Emerging Markets

Why do the emerging markets offer competitive market alternatives to the developed world? We look at three issues, starting with projected economic growth. Exhibit 1 shows projected economic growth rates by region and compares the developed markets to the emerging markets. The next five years are far more promising for China specifically and the emerging markets in general than the developed economies.

The second issue is indebtedness. The chart below shows that the developed nations will continue to labor under high levels of debt to GDP. This will cause those economies to grow more slowly. Exposure to the emerging markets, by comparison, means exposure to economies that have much less potential burden to higher taxes and greater regulation. This is because taxes tend to rise to pay off the new debt, and regulations are tightened in the hopes of preventing another financial crisis.

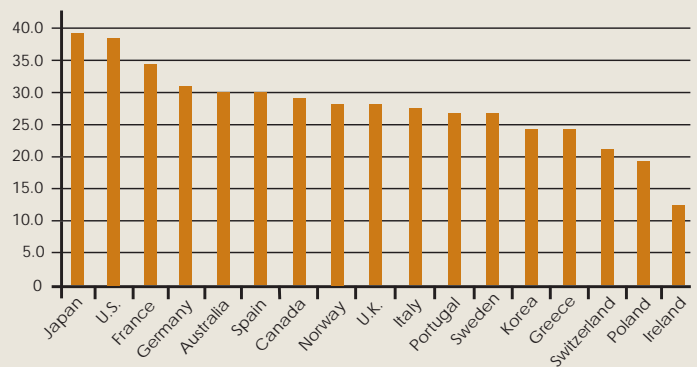
Exhibit 2: Debt to GDP



Source: International Monetary Fund

The third issue is existing tax rates, specifically on corporate earnings. From an investment point of view, a high tax rate punishes capital formation. Capital will be attracted to investments where there are lower taxes and fewer regulations. Currently, the U.S. has the second highest corporate tax rate among the Organization of Economic Cooperation and Development (OECD) countries. Japan's is higher and France's is slightly lower. These countries plan to cut their tax rates on corporations, leaving the U.S. with the highest rate.

Exhibit 3: Combined Corporate Income Tax Rate



Source: Organization for Economic Cooperation and Development

There are two other considerations. The rest of the world is growing so much faster than the U.S. that the U.S. represents a shrinking percentage of economic activity. At the end of 2009, the U.S. stock market represented 42% of the global stock market capitalization, down from 53% at the end of 2003. During the same time, the emerging markets' percentage grew from 5% to 13%. An investor's capital allocation should reflect where the market opportunities are being created. Second, valuation of the emerging markets continues to be reasonable when compared to the potential growth in those markets.

The Investment Conclusion

As investors and allocators of capital, we seek a variety of ways to gain exposure to emerging markets. Many of the companies we use in client portfolios have strong emerging market representation in their businesses. This is also true for our international managers, who look for companies with strong revenue generation from the emerging markets. We also pursue direct investment in the emerging markets, which we accomplish through exchange-traded funds and actively managed mutual funds. Finally, our global bond fund provides an effective way to access the positive trends noted above. For example, emerging market debt is often attractively priced with higher yields and the potential for credit upgrades. When these points of exposure are combined with a fully diversified portfolio, the contribution to performance and risk control can be very beneficial. ■

YEAR-END TAX PLANNING DURING UNCERTAIN TIMES

(continued from page 1)

There are, however, gifting opportunities that are unique to 2010. During 2010, lifetime gifts beyond an individual's \$1 million exemption are taxed at a comparatively low rate of 35%. Although this may not seem like a bargain, compared to the top rate of 55% that is scheduled to return in 2011, it does present a tax savings opportunity. In addition, this 35% rate is well below the top estate tax rate of 55% that is also scheduled to return in 2011. Making sizeable gifts and paying the associated gift taxes now could reduce the overall transfer taxes imposed on your family by reducing your taxable estate not only by the gift amount, but also by the future appreciation on the assets gifted, and if you survive for three years after the gift, by the gift taxes paid.

Estate Taxes: Much has been written about there being no federal estate tax during 2010. Under current law, if Congress does not pass legislation, the federal estate tax will come back into effect on January 1, 2011, with a \$1 million exemption and a top tax rate of 55%. Some believe that Congress will pass legislation before then, implementing a tax structure that is closer to the law in effect during 2009, with a \$3.5 million exemption and 45% top tax rate. Others hope for a \$5 million exemption. Although the uncertainty here does not necessarily present a planning opportunity for 2010 beyond the gifting considerations discussed above, it does suggest that when new legislation is in fact enacted, you should review your estate plan to make sure it is achieving your objectives in the most tax efficient manner possible.

Generation Skipping Transfer (GST) Taxes: During 2010 there is no GST tax. As you may recall, previously the GST tax applied to certain transfers or distributions to "skip persons" – generally grandchildren and more remote generations. The GST tax is scheduled to return at a 55% rate in 2011. Accordingly, 2010 may be an opportune year to make outright taxable gifts (at the "low" 35% gift tax rate) to grandchildren, without paying an additional 55% GST tax.

Another opportunity around the GST tax exists in certain trust situations during 2010. The trustees of non-GST exempt trusts may make distributions to beneficiaries who are skip persons without incurring GST tax. With a trust, there are always multiple factors to consider when determining whether a distribution is appropriate, with taxes being only one factor. For example, the trustee should consider the financial position of all potential beneficiaries and the appropriateness of providing funds outright to the skip beneficiaries. Due to the remote possibility that Congress may retroactively reinstate the GST tax for 2010, skip beneficiaries receiving trust distributions should reserve a portion of their distribution for possible GST taxes.

Conclusion

Our clients face an extraordinary degree of tax uncertainty as the end of 2010 approaches. We will be watching intently as Congress reconvenes to see what, if any, legislation emerges. In the meantime, please contact your tax advisor or Fiduciary Trust officer to discuss any of these planning possibilities. ■

By Jody R. King, CPA, JD, RLP®, Vice President

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NEWS AND NOTES

○ | **Fiduciary Charitable Foundation**

Our firm established the Fiduciary Charitable Foundation for clients who wish to make charitable gifts using appreciated securities. Securities given to the Foundation are immediately sold and the proceeds distributed to charities, as directed by the donor. A gift to the Foundation constitutes a tax-free contribution and the proceeds may be distributed at once or over a period of three years.

Using the Foundation to make charitable gifts has several advantages, including: (1) the convenience of making multiple gifts from a single block or multiple holdings of securities; (2) anonymity of the donor, if desired; and (3) processing simplicity for the charity, which receives a single check instead of one or more securities. The minimum security gift to the Foundation is \$1,000 and the minimum distribution to an individual charity from the Foundation is also \$1,000.

For more information about using the Foundation to simplify your charitable giving, please speak with your Fiduciary Trust representative.

○ | **Fiduciary in the News**

In July, President and CEO Doug Smith-Petersen was featured in two articles in a special "Wealth Builders" section of the *Boston Business Journal*. Doug was quoted in both a feature highlighting lessons learned during the recent market downturn and an article discussing the importance of client communication.

In August, the *American Banker* included a feature article about our recent advertising campaign. The article focused on Fiduciary Trust's sophisticated investment platform and outlined the goals and benefits of the new ads.