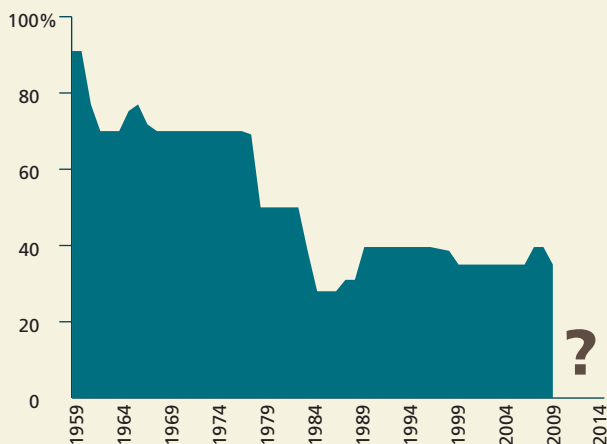


# Navigating a Changing Tax Environment: Timely Strategies for Today

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For decades, the United States had a top marginal tax rate as high as 50%, 70%, and even 90%. As a matter of fact, for the past 50 years there have only been five years, 1988 to 1992, when the top marginal tax rate was less than the current 35% tax rate. Considering the cost of the stimulus plan, soaring U.S. government debt, a \$3.72 trillion federal budget, a projected record-breaking \$1.6 trillion deficit, expiration of tax cuts that were passed in 2001 and 2003, and proposed tax legislation, income tax rates are sure to increase. As a result, every taxpayer will need to consult with their financial and tax advisers to implement investment and tax strategies that may benefit from a rising tax environment.

Top marginal tax rates for the past 50 years



Source: IRS, 2010.

At the end of 2010, certain federal income tax-reducing measures passed in 2001 and 2003 are set to expire. If these tax cuts are not extended, the two top tax rates of 33% and 35% will rise to 36% and 39.6%, respectively. Additional measures proposed in the President's budget include limiting the value of certain itemized deductions, such as mortgage interest and charitable contributions; capping the value of deductions by limiting the tax rate for filers who take itemized deductions to 28% instead of 39.6%; raising taxes on capital gains and qualified dividends to 20% from 15% (if the tax cuts are not extended); and reinstating the 45% estate tax for estates worth more than \$3.5 million, versus reverting back to a rate of 55% as we saw in 2001.

Could the tax rates continue to rise beyond 2011?

Factoring in the cost of the stimulus, the proposed 2010 and 2011 budgets, and a record federal deficit, many believe tax rates will have to continue to increase.

Accordingly, every investor should consider tax-reducing strategies. Below are potential strategies clients should address with their financial adviser and tax professional.

## 1. INCOME PLANNING STRATEGIES

**Accelerate income/postpone deductions.** A common income planning strategy in the past was to defer income to later years and take deductions as soon as possible. However, with the expectation that income tax rates will rise, some may want to actually accelerate income so it is earned in 2010 and taxed at historically low rates as

opposed to deferring the income to later years when the tax rates could be considerably higher. Conversely, it may make sense to defer certain deductible payments, such as charitable contributions, to a time when they may be worth more when the higher income tax rates take effect.

**Tax-loss harvesting.** A changing tax environment appears to be following on the heels of a major recession. As a result, taxpayers should spend time trying to identify valuable tax-loss harvesting strategies. For instance, many small businesses incurred a net operating loss in recent years. That loss can be passed down and used to offset the business owner's income on their personal tax return. The loss can also be carried forward to reduce income in future years. Generally, the value of these losses will be determined by the tax bracket of the owner in the year that he or she is using to offset income. In a rising tax environment, this loss becomes more valuable when income is subject to a higher tax rate.

**Take capital gains now.** This may be a good time to conduct a thorough "capital review." Review all capital assets, and estimate the unrealized gains or losses of those investments. With capital gains rates scheduled to increase to 20% if the tax cuts are not extended, it may make sense to take gains now while they would still be taxed at 15%. Conversely, consider deferring capital losses to offset capital gains in a year when they could be worth more due to the increase in capital gain tax.

Review other capital assets such as real estate, personal assets and certain business assets that are not depreciable or held for sale (inventory). Also, review certain retirement assets. Although distributions from qualified retirement plans are taxed as ordinary income, there is an exception to employer securities held in an employer-sponsored retirement plan. The appreciation of employer stock held in the plan will be taxed as a capital gain, and not as ordinary income, as long as the appreciated stock is distributed in-kind pursuant to a lump sum distribution.

Some taxpayers could avoid capital gain tax altogether. Married taxpayers with taxable income under \$68,000 (\$34,000 for single filers) pay no tax on capital gains in tax year 2009 or 2010. After adding in a standard

deduction of \$11,400 and a personal exemption of \$7,300 (\$3,650 for each), a married couple could have as much as \$86,700 of taxable income but pay no tax on capital gains (capital gains recognized will count toward the income limitation).

## 2. INVESTMENT STRATEGIES

**Municipal bonds.** The tax-equivalent yield of municipal bonds will increase as the income tax rates do. For someone in the current top tax rate of 35%, a municipal bond paying 3% will have a tax-equivalent yield of 4.6%. If the top tax rate increases next year, as it is now scheduled to do, the tax-equivalent yield of that same bond will increase also.

Tax Rate	Bond Rate	Tax-Equivalent Yield
35.00%	3.00%	4.60%
39.60%	3.00%	4.97%
50.00%	3.00%	6.00%

The above is a hypothetical example.

**Tax-efficient mutual funds.** Tax-efficient mutual funds with a buy and hold strategy may become more attractive in a rising tax environment. Each year, mutual funds pass short-term gains (taxed at ordinary income rates) and long-term gains (currently taxed as capital gains) on to the mutual fund investors. With the tax rates increasing for ordinary income and capital gains, mutual fund owners may likely pay more in taxes. Managers of tax-efficient mutual funds will look to help reduce short-term gains by potentially minimizing the turnover of the funds' underlying investments, investing in stocks that pay qualifying dividends, delaying recognition of gains and taking advantage of other tax-hedging strategies.

**Growth-oriented stock and mutual funds.** For the past several years, dividend-paying stocks have looked attractive because qualifying dividends were taxed at the same 15% rate as capital gains. If the tax cuts passed in 2001 and 2003 expire, dividends will be taxed at the higher ordinary income tax rates in effect at that time. As a result, we could see a shift from dividend-paying stocks and mutual funds to growth-oriented stocks and mutual funds.

**Life insurance and variable annuities.** For taxpayers who would like to pass an inheritance on to their beneficiaries, life insurance has always been a valuable tool. Since life insurance proceeds payable at death are not subject to an income tax, the value of those proceeds will increase as tax rates rise. If taxpayers are looking for an investment that could benefit themselves instead, annuities would be more attractive.

Annuities grow tax-deferred but when the gains are distributed, they will be taxed as ordinary income. However, when capital gain and ordinary income taxes both begin to rise, the tax deferral component of an annuity becomes increasingly more valuable.

### 3. RETIREMENT PLANNING STRATEGIES

**Maximize retirement plan/IRA contributions.** A key benefit to IRAs, 401(k) plans, and other qualified retirement plans is that they grow tax deferred. This benefit becomes more apparent as income taxes increase. Furthermore, the value of ongoing tax-deductible contributions into these plans may increase in a rising tax environment. For someone already in the 35% tax bracket, a \$10,000 contribution will save the taxpayer \$3,500 in income taxes. Next year, when the top tax rate is 39.6%, that contribution will save the taxpayer \$460 more. If tax rates increase, the same contribution may be worth even more. An obvious strategy in an environment of higher taxes would be to increase tax-deductible contributions to IRAs and qualified retirement plans.<sup>1</sup>

Tax Rate	Contribution Amount	Tax Savings
35.00%	\$10,000	\$3,500
39.60%	\$10,000	\$3,960
50.00%	\$10,000	\$5,000

The above is a hypothetical example.

**Roth IRA conversions.** A Roth IRA conversion in 2010 may be a good way to hedge against the risk of rising income tax rates. Convert a taxable retirement account to a Roth IRA now and pay taxes while the tax rates are relatively low and while the taxable value of the retirement account may be depressed due to the recent recession. A Roth IRA conversion can also help tax diversify a retirement portfolio. Retirees will have an account that

will grow tax-free and will be immune to whatever tax environment they retire into. The Roth IRA distributions are also tax exempt. By being able to supplement retirement income with tax-exempt income, retirees could increase the likelihood of keeping themselves in a lower income tax bracket.

### 4. GIFTING AND ESTATE PLANNING STRATEGIES

**Conduct an estate review.** Anticipated changes in the estate tax environment make it imperative to conduct an estate plan review. Effective January 1, 2010, both the estate tax and generation skipping tax were repealed. Both taxes are scheduled to return in 2011 but at more unfavorable rates than in 2009, with estates worth more than \$1 million being subject to a 55% estate tax. However, most believe that legislation will be passed this year, retroactive to January 1, 2010, reinstating a \$3.5 million estate tax exemption, a 45% estate tax rate, and the “step up” in cost basis. However, the current uncertainty of estate taxes would suggest that wealthy families take an inventory of their estate, determine whether assets are titled properly, and review all estate planning documents, including wills, trusts, and beneficiary designation forms.

**Intra-family transfers.** Since the tax increases are more likely to affect those in the higher tax brackets, the transfer of assets to family members in a lower tax bracket could become a compelling strategy. The spread between the tax rates of family members will be wider than before, and such a transfer will also reduce the transferor’s taxable estate.

In 2010, an individual can gift \$13,000 per person, per year without incurring a federal gift tax. That means a married couple with two children could transfer \$52,000 a year to the children without paying a gift tax.

Considering real estate, stocks, mutual funds and other

<sup>1</sup> When considering an annuity for use in an IRA, it’s important to first inform your client of the material features of the contract, and to base your recommendation on your belief that the client would benefit from factors other than tax deferral, which is already provided by the IRA, and that the client is willing to incur the costs associated with the annuity to receive such benefits. Such factors may include availability of guaranteed payments for life, guaranteed death benefit, or access to specific portfolio choices. Prior to recommending the purchase or exchange of a deferred variable annuity, be sure to make reasonable efforts to ascertain that your client’s financial objectives and financial situation are consistent with the long-term nature of an annuity, and to obtain any corroborative information that your firm considers to be reasonable in such circumstances. See the prospectus for details.

assets have decreased in value in recent years, a wealthy taxpayer may actually be able to transfer a larger portion of their taxable estate to their beneficiaries without paying a gift tax. Furthermore, any subsequent recovery of the loss in value of those transferred assets will be taxed at the beneficiaries' potentially lower income tax rates.

The use of 529 plans could become more popular in future years, based upon market conditions and the rising cost of college. These college savings plans can have fairly long investment time horizons whereby assets can grow tax deferred and distributions for qualified educational expenses can be taken tax free. Furthermore, individuals can accelerate their annual gift tax exemption and, subject to making the proper affirmative election, take five years' worth of exemptions in one year. That means a married couple could transfer \$130,000 into a 529 plan for each child and pay no gift tax. Finally, wealthy families may wish to pay a child or grandchild's tuition directly to the school. The payment would reduce their taxable estate but would not result in a gift tax or otherwise reduce or affect their annual gift exclusion amount.

The current low interest rate environment may make grantor retained annuity trusts (GRATs) more appealing. Parents and grandparents may wish to transfer assets, preferably investments that have declined in value or underperformed, to a GRAT. To the extent that the trust

assets grow more than 120% of the federal mid-term rate (sometimes referred to as the "hurdle rate"), those gains can be transferred as a gift to the trust beneficiaries tax free.

#### Annual intra-family transfer limits<sup>2</sup>



<sup>2</sup>Subject to making the proper affirmative election.

#### CONCLUSION

Although no one can accurately predict what the tax landscape will look like in the next few years and beyond, one thing is certain: tax planning will become a more important part of a taxpayer's overall strategy. The time to consult with financial and tax advisers is *now*.

**For more information on how to prepare for a changing tax environment, contact your financial adviser.**

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