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Ground Rules for 2007

Also: Voices of 2006, a Collection of Quotations

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Where are we? Is the stock market rising or falling? Did the real estate bubble burst yet? Does the Fed know what to do without Alan Greenspan? Will the Democrats use their new control of Congress to "repeal the repeal" of the estate tax? And what of the carryover basis for assets held at death…Congress was just kidding about that, right?

Welcome to 2007. It is a brand new year and for the financial planning and investing community, the context could not be any more dynamic. It is essential for professional planners to once again take stock of where we stand and what looms ahead in the immediate future.

As always, numerous limits are in flux due to phased-in changes from multiple tax laws. It is therefore time for another visit from the 2001-2011 chart to provide some perspective and identify exactly where we have come from and where we are heading. This issue also reviews key limits that have been affected by cost-of-living adjustments.

The Big Picture

This was the first year since 1987 without Alan Greenspan in charge of the Federal Reserve. His successor Ben Bernanke continued the steady increases of interest rates until midyear but, as the economy slowed, the Fed finally stopped increasing rates. From June 2004, through June 2006, there were 17 consecutive interest rate hikes that moved rates from 1% up to 5.25%. Despite a slowdown of the economy, new Chairman Bernanke announced that rates would not be coming down very quickly.

Oil prices spiked upward during portions of 2006 as mid-east turmoil sent oil prices past $78 a barrel and, in turn, led to concerns over the economy and inflation. The stock market dropped in response, with the Dow falling 400 points in one week of July. But oil prices receded significantly during the latter part of the year, corporate profits rose, the market soared, and the Dow Jones industrial average closed above 12,000 for the first time in October.

How will the economy and stock market fare over the next year? Several major factors will be in play. In the immediate future, an increase in the minimum wage will contribute to inflation. Down the road, if there is any plan to bring American troops home, expect stock market volatility. Investors have emotions that move the marketplace. Returning troops may increase demand on goods, but they will soon compete for jobs, curbing wage inflation.

Experts have indicated that our nation's economy will grow at a slower rate in 2007, somewhere between 2% and 3% rather than the 3.1% rate estimated for 2006 (which is down from the 3.6% predicted). This represents the tail end of the long expansion that began after the recession which followed September 11, 2001. U.S. corporate profits will increase by an estimated 6% to 8%, with equity markets growing by 8% to 9%. Returns may be higher in certain European and Asian markets. Thus, investors should consider diversification into international equity and investments in sectors with sustainable growth such as health care, consumer staples, and technology.

The Real Estate Bubble

Real estate values remained low, but did not collapse. Experts now appear to have reached a consensus that the real estate "bubble" is not about to burst—but the prospects for the next 18 months or so are sobering.

A study by Harvard University concluded that the surge of housing prices over the past five years has lead to overvaluation (with a 9.4% increase in average prices in 2005 alone), yet the long-term support for housing will result in a long period of stagnant pricing rather than a collapse. The National Association of Realtors predicts stability in 2007 despite the second consecutive year with a drop in the number of home sales. Sales dropped 8.6% in 2006 and are expected to drop another 1% in 2007. Merrill Lynch and Goldman Sachs predict declines in home prices by 5% and 3%, respectively, for 2007.

Why is real estate worthy of an estate planner's attention? First, almost every estate possesses real estate assets—68% of American households own their own home. If property values decline, it won't happen in a vacuum. Last year, high home equity offset high oil prices. This year, lower home values could impact consumer confidence and inhibit consumer spending, bringing the economy and stock market lower.

The Estate Tax Remaineth

Speaker of the House Nancy Pelosi targeted an increase in the minimum wage as a goal for the first 100 hours of Congressional work. But compromising on the repeal of the estate tax doesn't appear to be on quite as fast a track. Here's one observation, for whatever it is worth: In the movies, the ticking time bomb is always disarmed with only seconds to spare. In real life, nobody builds a stalemate into better drama than Congress. In past years, Congress has allowed budget impasses to shut down the government and has allowed critical tax provisions to expire, only to revise them retroactively.

In a perfect world, Congress would resolve the fate of the estate tax as soon as possible to allow citizens the basic ability to plan their estate ahead of time with some degree of confidence that they know what tax system will govern their estate.

In the real world, Congress is not truly forced to take action until the estate tax repeal takes effect in 36 months, i.e., January, 2010. ***Note:*** There is a presidential election on the horizon and a new administration will take office in 24 months. So there is some potential for compromise that restores a permanent estate tax with the larger exemption to be added to the next big tax package to come through Congress. However, don't be surprised if we are still wondering about the outcome with only a few months or weeks left in 2009.

Key Tax Thresholds for 2007

INCOME TAX BRACKETS: Top individual rates remain at 35%. For individuals, a 33% rate applies to income over $160,850. The 35% rate kicks in at $349,700 for individuals as well as married filing jointly. The first $97,500 of income is subject to Social Security tax withholding (up from $94,200 in 2006).

TOP ESTATE TAX RATE: The top estate tax rate has bottomed out at 45% after dropping by 1% a year for the last several years. But that's the last drop for a while. The tax rate will continue to hover at 45% in 2008 and 2009 and then drops to 0% in 2010.

ESTATE TAX EXEMPTION: We remain at $2-million estate tax exemption for 2007, the second of three years at that level. *(See chart, page four.)*

GENERATION SKIPPING TRANSFER TAX: Both the tax rate and exemption for estates apply to the GST tax, i.e., 45% and $2 million.

GIFT TAX RATE: Top rate also drops one percentage point to 45%, following the estate tax and the generation-skipping transfer tax.

GIFT TAX ANNUAL EXEMPTION: Last year, the gift tax annual exemption moved up $1,000 from $11,000 to $12,000 based on cumulative cost-of-living adjustments. This year the exemption remains at $12,000. With gift splitting, a married couple can give each beneficiary $24,000 free of gift tax each year. If current inflation trends remain in place, the next jump, to $13,000, will arrive in two or three years.

GIFT TAX LIFETIME EXEMPTION: The lifetime exemption for gift taxation remained at $1 million, and will remain at that level through 2011.

STATE DEATH TAX: The state death tax credit had been phased out. State death taxes are treated as a deduction. The number of states with some form of death taxes (24) seems to have stabilized. Some of these states have "decoupled" from the Federal approach.

SPECIAL-USE VALUATION: The aggregate decrease in value of an estate using §2032A for estate tax purposes was limited to $900,000 in 2006. This limit rises to $940,000 in 2007.

NON-CITIZEN SPOUSES: The exemption under sections 2053 and 2523(I)(2) for gifts to non-citizen spouses increased from $117,000 to $120,000 in 2006. For 2007, the limit increases to $125,000.

QUALIFIED FUNERAL TRUST: The limit is $8,800 for 2007.

CAPITAL GAINS: Top rates of 15% and 5% continue to apply. Rates rise in 2009 but a low bracket of 0% will exist in 2008.

ATTORNEY FEES: Amounts awarded increase to a rate of $170 per hour.

Note: *Revenue Procedure 2006-16, October 18, 2006*, containing a complete rundown of inflation adjustments relating to qualified retirement plans, is posted on the IRS website. *Revenue Procedure 2006-53* provides COLAs for additional provisions.

Medicaid Look-back Rules

The Deficit Reduction Act of 2005 enacted on February 8, 2006, increased the look-back period to look for outright gifts for Medicaid eligibility from three years to five years.

The look-back period for transfers to a trust was already five years. If gifts were made during the look-back period, a period of Medicaid ineligibility is calculated under state laws. Typically, this involves dividing the amount of the gift by the average monthly cost of nursing home care in that particular state.

Retirement Contributions

There was a time when individual retirement planning involved a one-size-fits-all approach involving the Individual Retirement Account. Everyone was eligible. The maximum contribution was always $2,000. There were no variations.

Nowadays, trying to summarize the planning options and rules is best accomplished with charts and graphs and a seminar. Nevertheless, here are some of the key numbers involved.

ELECTIVE DEFERRALS for 401(k) and certain other plans will have a contribution ceiling of $15,500 for 2007, up from $15,000.

CONTRIBUTION LIMITS increased from $10,000 to $10,500 for SIMPLE accounts, and from $44,000 to $45,000 for defined contribution plans, Roth IRA eligibility limits for 2007 are $99,000 of income for an individual, $156,000 for spouses filing jointly. Regular IRA contribution limits remain $4,000 for those 49 and younger ad $5,000 for those 50 and older.

COMPENSATION LIMITS for eligibility in SEPs and other plans increase to $225,000.

Voices of 2006

The world of finance is poorer for the loss of Kenneth Galbraith, Milton Friedman, and Louis Rukeyser during 2006. And there are others who shall be long remembered though they walk not this way again. Here are some of their notable remarks.

"Wealth is not without its advantages, and the case to the contrary, although it has often been made, has never proved widely persuasive." *—John Kenneth Galbraith, The Affluent Society (1958), ch. 1*

"We have in America a bad tendency that things have to be either serious or fun. Whereas in real life, this isn't true. The teachers we all remember in high school and college were not the ones who put us to sleep. I don't think any of us should apologize for not being dull." *—Louis Rukeyser*

"If you put the federal government in charge of the Sahara Desert, in five years there'd be a shortage of sand." *—Milton Friedman*

"Those big-shot writers could never dig the fact that there are more salted peanuts consumed than caviar."*—Mickey Spillane*

"It took me fifteen years to discover that I had no talent for writing, but I couldn't give up because by that time I was too famous."*—Peter Benchley*

"I'm fulfilled in what I do...I never thought that a lot of money or fine clothes—the finer things of life—would make you happy. My concept of happiness is to be filled in a spiritual sense." *—Coretta Scott King, the widow of Martin Luther King, Jr.*

"Now, more than ever, I feel Chris with me as I face this challenge. As always, I look to him as the ultimate example of defying the odds with strength, courage, and hope in the face of life's adversities."—D*ana Reeve, the widow of actor Christopher Reeve*

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Please accept our best wishes to you in 2007.

ESTATE TAX PHASE OUT, 2001 - 2011

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Income Tax Top Rate	39.1%	38.6%	35%	35%	35%	35%	35%	35%	35%	35%	39.6
Capital Gains	20% and 10%	20% and 10%	15% and 5% (after 5/5/03)	15% and 5%	15% and 5%	15% and 5%	15% and 5%	15% and 0%	20% and 10%	20% and 10%	20% and 10%
Dividends	Ordinary income	Ordinary income	15% and 5%	15% and 5%	15% and 5%	15% and 5%	15% and 5%	15% and 5%	Ordinary income	Ordinary income	Ordinary income
Gift Tax Top Rate	55%+	50%	49%	48%	47%	46%	45%	45%	45%	35%	35%
Gift Tax Exemption	$675,000	$1 million	$1 million	$1 million	$1 million	$1 million	$1 million	$1 million	$1 million	$1 million	$1 million
Estate Tax Top Rate	55%+	50%	49%	48%	47%	46%	45%	45%	45%	0%	55%+*
Estate Tax Exemption	$675,000	$1 million	$1 million	$1.5 million	$1.5 million	$2 million	$2 million	$2 million	$3.5 million	n/a	$1 million*
Basis at Death	Stepped-up basis	Stepped-up basis	Stepped-up basis	Stepped-up basis	Stepped-up basis	Stepped-up basis	Stepped-up basis	Stepped-up basis	Stepped-up basis	Carry over basis**	Stepped-up basis*

+ = In addition to the 55% rate, a 5% surtax is applied to certain estates exceeding $10 million.

* = In 2011, item reverts to 2001 level unless Congress enacts further legislation.

** For carryover basis in 2010 (and beyond if extended), a limited stepped-up basis would apply to the first $1.3 million.