

IMPLICATIONS OF THE 2010 TAX RELIEF ACT

Understanding income and wealth transfer tax relief //
Evaluating your plan and potential strategies // How to take action

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This white paper addresses financial planning opportunities in view of the tax provisions created by the Tax Relief, Unemployment Insurance, and Job Creation Act of 2010.

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INTRODUCTION

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In late 2009, most experts were confident the estate tax repeal scheduled for 2010 would never happen. It did. Through the early months of 2010, most experts were then pretty confident that the estate tax would be reinstated retroactively. It wasn't. As 2010 dragged on, some pessimistic experts began to speculate whether the 2011 \$1 million exclusion and 55% estate tax rate would become law. Further, they believed the favored income tax rates we have enjoyed for 10 years would expire and reset to pre-2001 levels. They didn't. The uncertainty caused by these events certainly left many experts confused and frustrated.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was assigned a Public Law number, P.L. 111-312, and was signed into law on December 17, 2010. However, this Act generally only extends its tax breaks for two years - 2011 and 2012. Thus, there are two perspectives by which to view this act's provisions. The first is as a window into the immediate future of both estate tax and income tax rates. This view reflects the inertia that will settle in requiring significant force and momentum to unwind what taxpayers have built into their financial and tax plans. The second view is that this truly is a brief respite ending late-2012 when the country will find itself in the same planning predicament we endured during 2009 and 2010.

Regardless, knowledge is the key to surviving the ride and effectively updating estate and tax plans. This paper offers a review of the changes enacted by the 2010 Tax Relief Act as well as insightful guidance and planning tips for investors to consider. What we may all find over the next two years is that planning may become more focused on what is really important: people, family security, nontax issues, asset preservation, management of investments, giving back and so on. And despite the fact that taxpayers and experts may all be put in the same frustrating position again of having to guess at where the law is going, effective planning can help better position investors going forward.

KEY TAKEAWAYS

The 2010 Tax Relief Act has provided investors with a two year window of certainty to plan within.



Income tax relief will have an immediate impact on the majority of investors but timely action may be required to receive the maximum benefits.



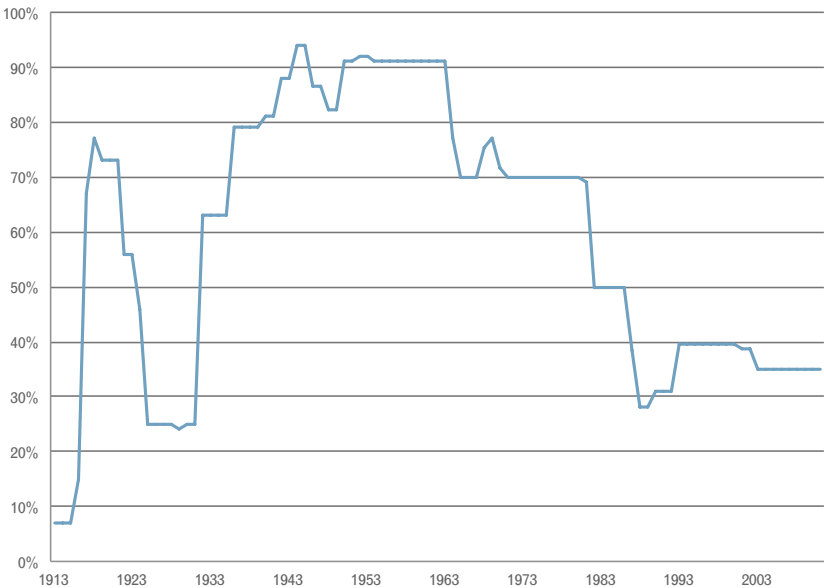
Estate and other wealth transfer tax relief have numerous planning implications for both large and small estates. A detailed plan review is recommended to ensure the best possible alignment with these complicated changes.

A BRIEF BACKGROUND

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased in reductions to the income and wealth transfer taxes based on massive budget surpluses forecast for the 2001 to 2010 decade. EGTRRA significantly reduced individual income tax rates and essentially eliminated both the estate and generation skipping transfer (GST) taxes effective January 1, 2010 – subject to a sunset provision.

Under the sunset provision, on January 1, 2011, the law returned to where it would have been had EGTRRA not been enacted. Individual income tax rates would have reverted from their current levels of 10%, 15%, 25%, 28%, 33% and 35% to 15%, 28%, 31%, 36% and 39.6%. The estate tax would be reinstated with a 55% top rate and a \$1 million estate tax exemption amount, and a flat 55% GST tax rate with a \$1 million exemption amount.

Top Marginal Income Tax Rate



Sources: Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; Tax Policy Center, Urban Institute and Brookings Institution, January 20, 2011 (<http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=213>)

FEDERAL TRANSFER TAX RATES AND EFFECTIVE EXEMPTIONS (BY YEAR OF TRANSFER)					
YEAR	ESTATE TAX			GIFT TAX	
	EXEMPTION	RATE (PERCENT)		EXEMPTION	TOP RATE
	(Millions of Dollars)	Bottom	Top	(Millions of Dollars)	(Percent)
2001	0.675	37	55 ^a	0.675	55 ^a
2002	1.0	41	50	1.0	50
2003	1.0	41	49	1.0	49
2004	1.5	43	48	1.0	48
2005	2.0	43	47	1.0	47
2006	2.0	45	46	1.0	46
2006	2.0	45	45	1.0	45
2008	2.0	45	45	1.0	45
2009	3.5	45	45	1.0	45
2010, 2011, 2012	5.0 ^b	35 ^b	35 ^b	1.0 (2010) 5.0 (2011/2012)	35

a. In 2001 a 5% surtax was imposed on wealth transfers between \$10.0 million and \$17.184 million. The surtax was designed to recapture the benefits of the graduated rate structure of the estate tax and results in an effective marginal tax rate of 60% on wealth transfers in that range.

b. Alternatively, the state of a 2010 decedant may elect the EGTRRA provision of no federal estate tax obligation and carry-over of the deceased's modified basis.

Sources: Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; Congressional Budget Office in Economic and Budget Issue Brief (December 18, 2009), Table 1, http://www.cbo.gov/ftpdocs/108xx/doc10841/12-18-Estate_GiftTax_Brief.pdf

From the above charts, it is clear that for the current two year period - 2011 and 2012:

- Top federal income tax rates remain near historic lows
- Federal transfer tax exemption amounts are high
- Federal transfer tax rates are low

PLANNING TIP:

Effective financial planning requires an awareness of both current and future tax environments. This means keeping an eye toward the future as part of an ongoing, goal-driven process.

CONSIDERATIONS FOR 2011 AND 2012

The 2010 Tax Relief Act provides individual taxpayers with relief under the federal income and wealth transfer tax regimes. The landscape of the tax law has and has not changed radically from 2010. In an ongoing effort to stimulate economic growth, Congress extended expiring income tax provisions and provided some new and additional wealth transfer tax relief. In doing so, Congress has created a tremendous number of opportunities for investors.

Bear in mind that this Act provides two years of tax relief. Course adjustments do not necessarily need to be immediately implemented. This tax relief provides certainty for two years. The objective should be to undertake well considered actions, or inactions, in the midst of this two-year planning window. This paper was designed to assist investors in identifying key areas worthy of consideration.

TAXATION BASICS

The U.S. imposes two main types of taxes on individuals:

1. Income tax
2. Wealth transfer tax

The federal income taxes concerning most investors include taxes on ordinary income, capital gains and dividend distributions. Generally, ordinary income tax is assessed on earned income, interest income and short-term capital gains. A short-term capital gain is the gain on sale of an asset held one year or less. Long-term capital gains and qualified dividend distributions are taxed at a lower, more preferential tax rate.

The federal wealth transfer tax system imposes a tax on transfers during life and transfers at death. The gift tax is assessed on lifetime transfers. The estate tax is assessed on transfers at death. A third tax, the generation skipping transfer (GST) tax is assessed on any transfer – lifetime or at death – of wealth to grandchildren and subsequent generations.

Basic Strategies

With the robustness of the federal tax system generating numerous and often complex tax planning techniques, it can be difficult for investors to settle on an appropriate tax strategy or strategies. Perhaps taking a fresh look from a three-thousand-foot vantage point is in order to provide a foundational understanding.

The well established consensus is that there are four basic strategies:

- Tax free
- Tax acceleration
- Tax deferral
- Tax diversification

Tax free income is attractive to investors attempting to manage their income tax rate. Such investors are particularly attracted to municipal bonds because, in many cases, their income is not only excluded from federal income tax calculations but from state and local income tax calculations as well.

Accelerating taxes into the current tax year may be desirable if you expect to be taxed at a higher rate in the future and for investors subject to the alternative minimum tax (AMT) in the current year. Popular income tax acceleration techniques include sale of investment assets, Roth IRA conversions, and electing advance payments of future years' compensation or income.

For those who expect to be taxed at a lower rate in future years, deferring taxation may be the more suitable course. Tax deferred compounding has the potential to provide significantly superior investment performance over time. Short term deferral techniques include investments in Treasury bills and certificates of deposit. Longer term deferral can be achieved through annuities and IRAs, employer sponsored retirement plans such as 401(k) and non-qualified deferred compensation plans, and like-kind exchanges.

Tax diversification is essentially a balancing of the first three strategies: tax-free, tax acceleration and tax deferral. Tax diversification is attractive to investors who are not certain whether their future tax rates will be higher or lower and those who want to diversify across types of taxable income. This is where the majority of investors instinctively position themselves as they strive to increase their annual spendable cash flows and invest in tax-deferred savings vehicles.

INCOME TAX RELIEF

Nothing immediately impacts the majority of investors more than income tax relief. Certain relief provisions of the Act require no action by investors in order to yield a benefit. Others require timely and specific action.

ORDINARY INCOME TAX RATES RETAINED

2010 Federal income tax rates will be held steady for 2011 and 2012.

INDIVIDUAL TAXPAYERS	
If taxable income is:	Your tax is:
Not over \$8,500	10% of your taxable income
Over \$8,500 to \$34,500	\$850 + 15% of the excess over \$8,500
Over \$34,500 to \$83,600	\$4,750 + 25% of the excess over \$34,500
Over \$83,600 to \$174,400	\$17,025 + 28% of the excess over \$83,600
Over \$174,400 to \$379,150	\$42,449 + 33% of the excess over \$174,400
Over \$379,150	\$110,016.50 + 35% of the excess over \$379,150
MARRIED FILING JOINTLY	
If taxable income is:	Your tax is:
Not over \$17,000	10% of your taxable income
Over \$17,000 to \$69,000	\$1,700 + 15% of the excess over \$17,000
Over \$69,000 to \$139,350	\$9,500 + 25% of the excess over \$69,000
Over \$139,350 to \$212,300	\$27,087 + 28% of the excess over \$139,350
Over \$212,300 to \$379,150	\$47,513.50 + 33% of the excess over \$212,300
Over \$379,150	\$102,574 + 35% of the excess over \$379,150

PLANNING TIP:

When determining how much and whether to accelerate income, consider the current tax rate schedules. It may be advisable to simply “run the bracket” – drive income up to the top of the current bracket without going over

Example: With 2011 taxable income of \$25,000, Lars is subject to a top income tax rate of 15%. He believes his tax rate will be higher in retirement. He decides to accelerate income by converting his \$18,000 traditional IRA to a Roth IRA.

Lars decides to “run the bracket” and converts only \$9,500 (\$34,500 - \$25,000). He knows that for each additional dollar converted he would have to pay ten cents more in income tax as the 25% rate would apply to those dollars.

Source: Internal Revenue Service

LONG-TERM CAPITAL GAINS AND QUALIFIED DIVIDEND RATES EXTENDED

Long-term capital gains (LTCG) and qualified dividend distributions are tax-free for those subject to the 10 and 15% income tax rates. See tax schedule inset, above. All others are subject to a 15% rate. A special 28% rate still applies to the gain on sale of collectibles such as antiques and works of art.

ITEMIZED DEDUCTIONS NOT SUBJECT TO OVERALL PHASE-OUT

The overall phase-out of IRS Form 1040, Schedule A itemized deductions, continues to be eliminated for 2011 and 2012. Prior to 2006, the ability to claim itemized deductions was reduced by 3% of excess Adjusted Gross Income (AGI) over the applicable threshold, but by no more than 80% of total itemized deductions. The applicable AGI threshold for 2009 was \$166,800.

Certain items are, and presumably will remain, exempt from phase-out. These are medical expenses in excess of 7.5% of AGI; investment interest expenses; and casualty, theft and wagering losses.

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PLANNING TIPS:

For 2011 and 2012, cash flows generated by net LTCG and qualified dividend income may yield significant income tax savings over cash flows generated by ordinary and interest income.

Convert ordinary income into LTCG. Considering selling an appreciated asset held for one year or less? Reconsider. Holding that asset for a year and a day will convert what would have been short-term gain on the sale to a long-term capital gain. Of course, investors must weigh the chance that the asset will decline in value.

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PLANNING TIP:

Bunch deductible expenses in one tax year to maximize the use of available deductions.

Example: In 2011, Kurt has incurred medical expenses equal to 6% of his AGI. In 2012, he will also incur medical expenses equal to 6% of his AGI.

Kurt decides to accelerate his planned 2012 medical expenses into 2011 to exceed the 7.5% AGI threshold (2011) and claim an itemized deduction for medical expenses equal to 4.5% of his AGI (12% - 7.5%).

AMT PATCHED EARLY IN 2011

Prior to 1970, very high income taxpayers were able to take advantage of the many deductions and exemptions as to drive down their Federal income tax liability. To curtail that activity, Congress enacted an alternative minimum tax (AMT) in 1970. Unfortunately the AMT exemption amount, income threshold – the threshold for application of the AMT – and brackets were not indexed for inflation so the AMT captures a significant number of middle-income taxpayers today.

To circumvent this unintended result, Congress traditionally provides one-year “patches” to the AMT exemption. For 2011, the AMT exemption amount has been increased to \$48,450 for single filers and \$74,450 for married taxpayers filing joint returns. Had Congress not implemented this patch, the exemption amount would have been much lower at \$33,750 and \$45,000 (SF/MFJ).

PLANNING TIP:

Deferring income and/or accelerating deductible expenses may trigger the AMT. Investors consistently subject to the AMT and those that fall in-and-out of the AMT should plan carefully before taking either action.

CERTAIN MISCELLANEOUS ITEMS RENEWED FOR 2011

In addition to the AMT patch, Congress traditionally extends or retains several other relief provisions with popular support. These include the:

- \$250 above-the-line deduction for qualified expenses incurred by elementary and secondary school teachers
- \$1,000 child tax credit
- \$2,000 Coverdell education savings account contribution limit
- Earned income credit
- Hope and Lifetime Learning credits for higher education
- Ability to claim an itemized deduction for state and local sales taxes

PLANNING TIPS:

Up to \$2,500 of qualified student loan interest may be deductible.

The ability to contribute to a Coverdell education savings account is subject to phaseout. Grandparents subject to phaseout should consider having the child make his or her own contribution. How? Simply make a gift of up to \$2,000 to the beneficiary child and have the child's custodian contribute the funds for the child.

MARRIED TAXPAYERS RECEIVE "MARRIAGE PENALTY" RELIEF

A married couple filing a joint return is said to be subject to a "marriage penalty" when the tax liability on their joint return exceeds the sum of their tax liabilities calculated as individual filers. The Act extended EGTRRA changes which eliminated two marriage penalties by increasing the (1) standard deduction and (2) the top threshold of the 10 and 15% income tax rate brackets to twice that of individual filers.

PLANNING TIPS:

Certain married taxpayers filing joint returns with taxable income in excess of \$139,350 may still be subject to tax rate marriage penalty.

Example: Tomas and Maria each have taxable income of \$80,000 for 2011. As individual filers, they would each be subject to the 25% tax rate and have a tax liability of \$16,125. Were they to marry and file a joint return, their combined taxable income of \$160,000 would be exposed to the higher 28% rate creating a \$32,869.50 tax liability – \$619.50 higher than their combined individual tax liabilities.

Another example of a marriage penalty is that individual filers and married couples filing jointly are subject to the same restriction on the ability to use excess capital losses to offset ordinary income – a flat \$3,000.

QUALIFIED CHARITABLE IRA DISTRIBUTIONS ALLOWED FOR 2011

Investors who have attained the age of 70½ may direct their IRA custodian or trustee to pay a tax-free distribution of up to \$100,000 directly to their favorite qualified charity. If the amount of the qualified charitable distribution (QCD) meets or exceeds the investor's 2011 required minimum distribution (RMD), he will be considered to have met his RMD requirement.

PLANNING TIP:

Simply withdrawing IRA funds and subsequently donating them to charity results in (1) taxable ordinary income and (2) a charitable deduction. For many taxpayers, the charitable deduction allowed does not fully offset the income tax obligation on the withdrawn amount.

Therefore, a QCD may be more tax-efficient.

Example: Wayne is required to withdraw a \$20,000 RMD from his IRA this year. He would also like to donate \$20,000 to aid his local library as a QCD. Wayne instructs his IRA custodian to distribute \$20,000 directly to the library.

Wayne has met his 2011 RMD requirement and does not owe any income tax on this IRA distribution. Wayne, however, may not claim a deduction for the charitable donation.

2% SOCIAL SECURITY PAYROLL TAX CUT

Congress has granted employees a temporary Social Security payroll tax rate cut from 6.2% to 4.2%. Self employed individuals were granted a similar 2% reduction to their self employed tax rate from 12.4% to 10.4%. Employees and self employed individuals have already felt the impact of this particular provision on their pocketbooks.

PLANNING TIP:

Retirement account accumulations a little lackluster? Don't treat the increase in take-home money generated by this relief as "found money." Take this opportunity to painlessly increase your 2011 IRA or 401(k) salary deferral amount before you get used to having that "little extra" in your pocket.

WEALTH TRANSFER TAX RELIEF

This congressional action has dramatically simplified the wealth transfer tax system for the vast majority of taxpayers. The new Act:

- Reunifies the gift, estate and generation skipping transfer (GST) at a
- 35% maximum tax rate with a
- \$5,000,000 exemption amount, per individual, and
- Allows a surviving spouse to use a deceased spouse's unused exemption.

During life, anyone may give up to \$13,000 (2011) per year to as many individuals as they would like without triggering any taxes. Couples may give a combined \$26,000 (2011). Transfers in excess of that amount are generally subject to a gift tax.

Transfers at death are subject to the estate tax. Years ago wealthy individuals would avoid multiple layers of estate tax by making lifetime gifts, devises or bequests to grandchildren and younger generations. The GST tax was designed to capture the estate tax that would have been imposed on each of those "skipped" transfers.

The planning implications of the new Act are numerous and tremendous. Some are elementary, some complex; but all plans should be reviewed for potential benefits. Large estates will benefit the most, yet nearly every estate will benefit in some way.

\$5 MILLION UNIFIED GIFT, ESTATE & GST TAX EXEMPTIONS

Before 2004, the gift and estate tax exemption amounts were the same. That is to say they were fully unified. Although the GST tax exemption amount fell in line with the estate tax exemption amount, it has marched to the beat of a different drum with its flat tax rate.

The new Act unifies the gift, estate and GST tax exemption amounts and indexed them for inflation in following years. For 2011; no gift, estate or GST tax is imposed on the first \$5 million in wealth transferred away. Each individual is entitled to this exemption amount and may use it during life or at death. 2011 wealth transfers in excess of this exemption amount may be subject to a 35% gift, estate or GST tax.

In the meantime, individuals who have previously exhausted their \$1 million (2010) lifetime gifting limit are now able to transfer an additional \$4 million gift, estate and GST tax free. Married couples may now transfer up to a total of \$10 million federal estate tax-free.

The corresponding increase in the GST tax exemption amount significantly increases the ability to preserve family wealth through multiple generations.

PLANNING TIPS:

Investors who are able to afford large gifts, yet are uncomfortable relinquishing complete control over such sums to an intended beneficiary, should consider placing the gift in a trust for the benefit of the intended individual(s).

State gift, estate and GST tax exemption amounts could differ significantly from the new Federal exemption amounts. Be sure to check your state's applicable exemption amounts.

35% UNIFIED MAXIMUM GIFT, ESTATE AND GST TAX RATES

Under the new unified system, a single rate schedule applies to all types of transfers with the maximum rate of 35% (2011). These rates are progressive and are applied to the cumulative amount of wealth transferred in excess of the \$5 million exemption discussed previously. The system was unified in an attempt to treat all transfers the same regardless of whether they occurred during life or at death. But while the value of a dollar transferred during life is the same as a value transferred at death under the transfer tax system, the impact on wealth transfer is anything but equal.

In fact, large lifetime transfers of wealth may have just become the most important planning tool investors have during the 2011 and 2012 two-year period of certainty. Instead of focusing on how the transfer is taxed, focus on what it can achieve:

- Wealth transferred during life is removed from the estate,
- Which means future appreciation is removed from the estate,
- The \$5 million exemption amount may be locked in while we have it,
- Future income can be shifted to individuals in a lower income tax bracket, and
- The wealth transferred and subsequent appreciation may now be creditor, spendthrift and divorce protected.

An additional benefit to taxable lifetime transfers is the very nature of how the transfer tax is imposed. A transfer during life is tax-exclusive. A transfer at death is tax-inclusive.

For longer term planning, remember that these changes are also scheduled to sunset in 2012 with reversion to the old 55% maximum rate for 2013.

PLANNING TIPS:

For 2011 and 2012, the true value of lifetime gifts may lie in the ability to use them to preserve or create family wealth. One simple method is to make tax exempt or taxable lifetime gifts to a dynasty-type, or multi-generational, trust and use the gifted funds to pay life insurance policy premiums. The insurance proceeds held by the trust may be removed from the wealth transfer tax system for generations.

Example: Assume Josh has a taxable estate and \$100,000 earmarked for his brother Anthony. Josh has two options:

1. Die and leave Anthony \$100,000. Josh's estate pays an estate tax of \$35,000, or 35%. Anthony receives a net \$65,000. In summary, $\$100,000 - \$35,000 = \$65,000$ for Anthony at some future date; or
2. Make a taxable gift to Anthony in 2011. Josh gives Anthony \$74,074 and Josh pays a gift tax of \$25,926, or 35%. Anthony ends up with \$74,074 versus \$65,000. This is a dramatic example, but shows the power of making lifetime gifts.

Unless the giver dies before 2013, when the estate tax rate is scheduled to revert back to a maximum rate of 55%, the gift tax rate incurred will have been less than the applicable estate tax rate.

STEP-UP IN BASIS RULES REINSTATED

The aptly named “step-up in basis” rules have been reinstated effective 2010. Under the step-up rules, the recipient of inherited property receives a basis which is stepped up or down to the fair market value of the asset.

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PLANNING TIP:

Inherited property is automatically recharacterized as LTCG property regardless of how long the deceased or the heir held the property before eventual sale.

Example: Richard passed away holding XYZ stock with a FMV of \$50,000 and an adjusted cost basis of \$2,000. Sandra Louise, Richard's sole heir, received the stock with a stepped up \$50,000 cost basis.

PORTABILITY PROVIDED FOR UNUSED EXEMPTION AMONG SPOUSES

A basic tenet of estate tax exemption planning is now outdated: use it or lose it. Previously, unused exemption amounts passed with the individual. Under the new act, if the first spouse to die passes in 2011 or later, the surviving spouse now has access to the deceased's unused exemption.

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PLANNING TIPS:

The executor of the first spouse to die must make an affirmative election to transfer the deceased's unused exemption amount to the surviving spouse.

Most married couples no longer need the familiar credit shelter, or family, trust (CST) to fully utilize the exemption of the first spouse to die. But, there are still valid asset preservation and tax planning reasons to retain or incorporate CST provisions in estate planning documents.

Example: Charles passed away early in 2011 having used only \$1 million of his available \$5 million estate tax exemption amount. If his surviving spouse, Dorothy, passes in 2011 or 2012, her own \$5 million exemption amount is not sufficient to shelter her \$6 million estate. Dorothy, however, is entitled to an aggregate \$9 million exemption: her own \$5 million exemption plus Charles' unused \$4 million exemption. Her aggregate exemption will completely shelter Dorothy's estate from tax.

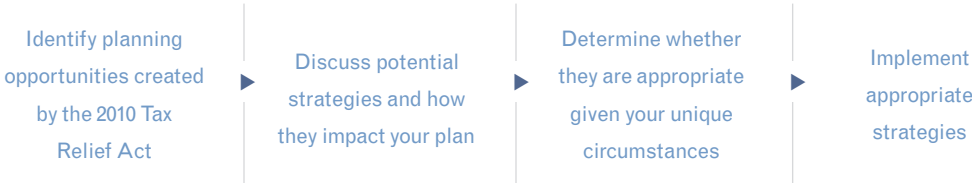
CONCLUDING COMMENTS

Investors enjoy more planning options now than in recent years past. Their only real questions are: “Should they plan for the current law staying with us for the long-term?” And, “What will happen in 2013?” The realistic response is that Congress may act to significantly change the situation again, perhaps implementing more onerous income and wealth transfer taxes across the board. A well tailored plan is certainly in order.

For what may be a short two-year period, investors have the opportunity to take advantage of some uniquely favorable income and wealth transfer tax laws. Whether exercising options to accelerate income and take advantage of historically low income tax rates, or by leveraging lifetime gifts to trusts with life insurance, current law offers investors what may very well be a once in a lifetime opportunity to realize extremely significant tax savings. Plan – and act – accordingly.

WORK WITH YOUR FINANCIAL ADVISOR

Tax planning is an important and complicated part of a comprehensive financial plan. Lower tax bills may be important, but they are not the only important consideration. To maximize overall portfolio performance and tax results, review short- and long-term objectives, portfolio asset allocation, and investment diversification before taking action. You should work closely with your financial advisor as well as other relevant tax professionals to:



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