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In This Issue...

- [Keep Your Estate Plan Flexible](#)
- [Gifting Considerations](#)
- [What Happens if You Become Disabled?](#)
- [Watch Out for These Portfolio Mistakes](#)
- [Painful Lessons about Saving for Retirement](#)



Keep Your Estate Plan Flexible

Estate planning has become more difficult in recent years due to changing estate tax laws. Estate tax rates and exemption amounts keep changing, increasing to \$3,500,000 this year. Next year, the estate tax will be repealed, but it will be reinstated the following year based on 2001 tax laws. All these changes can make it difficult to determine whether your estate plan should be revised due to new changes. Thus, it is increasingly important to build flexibility into your estate plan. Some points to consider include:

- **Find ways to incorporate changing exemption amounts in your estate plan.** Many estate planning documents indicate that trusts should be funded with assets equal to the estate tax exemption amount or generation-skipping transfer tax exemption amount. Evaluate whether those amounts are still appropriate considering their current high levels. Those amounts may leave more than intended to certain heirs or may place so much in a credit shelter or other trust that your spouse may receive very little of your estate outright. You may want to set a cap on the amounts placed in trust, even if that means you won't fully utilize your exemption amounts.
- **Make sure you have enough solely owned assets to fund these trusts.** Once you have decided how much should be placed in trust, make sure you have sufficient assets titled in your own name. Assets that you own jointly with your spouse or another individual will automatically go to that person, rather than to the trust, after death.

- **Consider adding a disclaimer provision to your estate planning documents.** This provision details what will happen if one of your heirs disclaims his/her inheritance. That way, your heirs can decide after your death how much should be placed in various trusts. For instance, a husband can leave all his assets to his wife with the condition that any disclaimed assets go into a trust paying her income for life, then passing the principal to their children after her death. This gives the wife the opportunity to divide assets based on her needs and wishes at the time of her husband's death.
- **Review your gifting strategies.** You may still want to continue gifting strategies to utilize your annual gift tax exclusion (\$12,000 in 2009 or \$24,000 if the gift is split with your spouse) and your lifetime gift tax exclusion amount. For those with estates large enough to be subject to estate taxes, these strategies remove assets from your taxable estate without paying any gift taxes. When using your lifetime exemption amount of \$1,000,000, look for ways to maximize your tax-free gift. For instance, individuals who transfer noncontrolling interests in businesses, farms, real estate, and other assets during their lifetime may be able to assign a minority interest discount to the gift's value. By gifting assets to certain types of trusts, such as qualified personal residence trusts and grantor retained annuity trusts, you can place an asset in trust now, retain use of the asset for a period of time, and assign a lower value to the gift.
- **Consider making charitable contributions during your lifetime.** While charitable contributions made after death are free of estate taxes, that may not be a consideration due to higher exemption amounts. Charitable contributions made during your lifetime will still lower your taxable estate, and you receive an income tax deduction currently.
- **Reevaluate your life insurance needs.** Since the estate tax will only be repealed for the year 2010, you may still want life insurance to help your heirs pay estate taxes. Even if you die in the year 2010, any inherited assets will not receive a step-up in basis, perhaps leaving your heirs with a large capital gains tax burden.
- **Review how specific assets are distributed.** In 2010, inherited property will have a basis equal to the lesser of the decedent's adjusted basis or the property's fair market value at the decedent's date of death, with three exceptions: 1) \$1,300,000 of basis can be added to assets. 2) Unused capital losses, net operating losses, and certain built-in losses can increase this cap. 3) An additional \$3,000,000 of basis can be added to assets inherited by a surviving spouse. Due to these exceptions, you may want to specifically allocate assets with low bases to your spouse and assets with a higher basis to other heirs to ensure the step-up in bases is maximized.
- **Go over your entire estate plan at least every three years.** No matter how much flexibility is built into your estate plan, you should still thoroughly review your plan every three years or so. Even if there are no major changes in the estate tax law or your personal situation, such as a

marriage, death, divorce, or birth, gradual changes in your situation, such as an increasing net worth or a decline in your investment portfolio, may make changes to your estate plan necessary.

[Back to topics.](#)



Gifting Considerations

Deciding whether you should give a significant asset to an heir during your life or after your death has typically involved weighing potential estate tax costs against capital gains taxes that would be due when the asset is sold.

You can make annual gifts, up to \$12,000 in 2009 (\$24,000 if the gift is split with your spouse), to any number of individuals without paying federal gift taxes. There is also a lifetime gift tax exemption of \$1,000,000 (\$2,000,000 if the gift is split with your spouse). The basis of any gifts made during your lifetime equals your basis plus any gift taxes paid on the gift.

The estate tax exclusion is \$3,500,000 in 2009, with a 45% estate tax rate. The basis of any assets distributed to heirs after your death is stepped up to fair market value on the date of your death. With such a large exclusion amount, you can transfer assets with fairly significant values to heirs without paying estate taxes, while still stepping up the basis to fair market value. However, keep in mind that the estate tax will be repealed in 2010, with special rules in effect for bases adjustments in that year. In 2011, the estate tax will be reinstated based on 2001 tax laws, with a \$1,000,000 estate tax exclusion amount.

Thus, when making gifts, you have historically had to evaluate whether it was better to make the gift after death so your estate will pay estate taxes on the value or during your lifetime so your heirs will pay capital gains taxes when the asset is sold. With much larger exclusion amounts, many individuals do not need to focus on estate taxes. Instead, gifts should be made in a manner that will reduce overall income and capital gains taxes for the family. Some strategies to consider that may help accomplish this objective include:

- **Transfer low-basis assets after death.** When heirs receive an asset that has increased significantly in value after your death, its basis is stepped

up to market value. They retain your basis when it is received during your lifetime, so significant capital gains taxes may be due when the asset is sold. However, if you plan to sell the asset in the near future, you should evaluate the tax impact if you own the asset or your heirs own the asset. Especially if you are going to use the proceeds for your heirs' benefit anyway, there may be a lower capital gains tax bill if your heirs sell the asset. Capital gains taxes are currently 15%, but through 2010, taxpayers in the 10% or 15% tax bracket pay no capital gains taxes.

- **Consider using an estate defective trust (EDT) to transfer significant low-basis assets.** Once the asset is placed in trust, any income from the asset is allocated to the trust or the trust beneficiaries, who will typically be in a lower tax bracket. However, the asset is still considered part of your estate, so beneficiaries will receive a step-up in basis after your death.
- **Reevaluate buy-sell agreements for businesses.** Often, buy-sell agreements are funded with life insurance. If one owner dies, the other owners use the life insurance proceeds to purchase the deceased owner's shares. If the life insurance is owned by the company, the proceeds are paid to the company, and the remaining owners do not receive a step-up in basis. If each owner owns life insurance on the other owners, the proceeds will be paid to each remaining owner. Those owners can then use the proceeds to purchase shares from the company at fair market value, in essence receiving a step-up in basis.
- **Review discounting techniques carefully.** Many estate planning strategies have involved the use of discounts to reduce the fair market value of the transferred assets. For instance, individuals who transfer noncontrolling interests in businesses, farms, real estate, and other assets may be able to assign a minority interest discount to the gift's value. As long as the gift won't result in the payment of gift or estate taxes, your primary goal will be to increase the basis as much as possible.

[Back to topics.](#)



What Happens if You Become Disabled?

For many people, a long-term disability would be financially devastating. Although no one likes to think about this possibility, you should consider your options now so you can obtain disability income insurance if needed.

Many individuals can find the funds, even though it might be difficult, to get through a short-term disability of six months or less. Find out what benefits you would be entitled to under sick leave policies, short-term disability policies provided by your employer, and workers' compensation. Another source of funds might be your emergency fund of three to six months of living expenses.

When considering a long-term disability, assess your income needs until age 65, when presumably retirement benefits would begin. During this analysis, consider the following items:

- **Estimate your monthly expenses following a disability.** Typically, some of your disability benefits would be free of income taxes (if you paid the premiums), and you won't incur work-related expenses. However, don't underestimate your expenses, since your medical and rehabilitation expenses might be much higher after a disability. Find out if you would continue to be covered under your employer's health insurance plan. If not, you'll need to make provisions for that expense.
- **Review your annual Social Security Statement for an estimate of disability benefits.** However, keep in mind that the eligibility requirements are quite stringent - you must be totally disabled, have little or no chance of recovery, and wait six months or longer for your first check. Even if you do qualify, benefits tend to be modest.
- **Decide what personal resources you would want to use.** You can access funds from individual retirement accounts, annuities, or 401(k) plans without penalty if you are disabled. But first consider whether you want to risk depleting your retirement fund or children's college fund due to a long-term disability.
- **Investigate any long-term disability benefits provided by your employer.** Long-term group disability plans are less common and typically less common than short-term plans. The policies frequently have strict definitions of disability, pay up to 60% of your base salary (bonuses and commissions generally aren't included), pay two to five years of benefits, and don't provide cost-of-living increases. Also factor in income taxes that must be paid on any benefits your employer paid for. Check to see if your employer-sponsored retirement plan offers an option for early retirement in case of disability.
- **Consider purchasing disability income insurance to fill any gaps.** However, you might not be able to replace more than 60% to 80% of your income through insurance, since insurers want you to have an incentive to return to work. Any benefits from policies you paid the premiums for are received income-tax free. Coordinate your employer-provided insurance and your own policy so that the maximum benefits do not exceed the amount the insurance companies will pay. Otherwise, you may pay for coverage you won't receive.

If you decide to purchase disability income insurance, make sure to consider these things:

- **Pay special attention to the definition of disability.** There are three basic types of coverage: own occupation, any occupation, and income replacement. Own occupation pays benefits when you can't work at your specific occupation. Many professionals, such as doctors and lawyers, opt for this coverage. However, due to substantial claims, this coverage is now more difficult to obtain. You may be able to find own occupation coverage for a specified period, with the policy then converting to any occupation coverage. Any occupation means you must be unable to work at any occupation that your training and education would be suited for. Income replacement policies pay the difference between what you were earning before the disability and what you are earning now. For most individuals, income replacement policies will provide the best balance between cost and benefits.
- **Opt for a long waiting period before benefits start.** This is a good way to reduce premiums, provided you have other resources to rely on for the short term, such as sick leave, personal savings and investments, and short-term disability coverage. Waiting periods can range from one week to two years, but the most common option is a 90-day delay in benefits.
- **Consider coverage that pays benefits until age 65.** Disability insurance is designed to protect your financial situation from a serious disability, so you should obtain coverage for the long term. Policies for lifetime benefits are rare and expensive. It's probably not needed, however, since you will probably be eligible for Social Security and other retirement benefits once you turn 65.
- **Look for a policy that provides residual benefits.** This allows you to return to work on a part-time basis and still receive partial benefits.
- **Make sure the policy is either noncancelable or guaranteed renewable.** Noncancelable means you can renew the policy every year at the same premium. Guaranteed renewable means you can renew the policy every year, but the premium can increase as long as it is not done so in a discriminatory manner. Either provision will ensure that the policy can't be canceled due to medical problems.

[Back to topics.](#)



Watch Out for These Portfolio Mistakes

Investing is a gradual process - purchasing some investments and selling others as the years go by. After a period of years, this can result in a mixture of investments that don't fit your overall investment strategy. Thus, periodically review your portfolio, watching out for these mistakes:

- **You don't use an asset allocation strategy.** Many investors select individual investments over the years, not considering their portfolio's overall makeup. Add up all your investments and calculate what portion is invested in each investment category. Assess your current allocation and determine whether it fits your personal situation.
- **You have too many investments that aren't adding diversification to your portfolio.** Diversification helps reduce the volatility in your portfolio, since various investments will respond differently to economic events and market factors. Yet it's common for investors to keep adding investments to their portfolio that are similar in nature. This does not add much in the way of diversification, while making the portfolio more difficult to monitor. Keep in mind that diversification does not ensure a profit or protect against loss in a declining market.
- **Your portfolio's return is lower than benchmark returns.** While everyone likes to think their portfolio is beating the market averages, many investors simply aren't sure. Review the return of each component of your portfolio, comparing it to a relevant benchmark. While you may not want to sell an investment that has underperformed for a year or two, at least monitor closely any investments that significantly underperform their benchmarks. Next, calculate your portfolio's overall rate of return and compare it to a relevant benchmark. Also be sure to compare your actual return to the return you targeted when setting up your investment program.
- **You trade too frequently without adequate research.** With so many choices and so much information, it's tempting to trade often based simply on other people's recommendations. Yet, besides the tax and trading costs associated with trades, frequent traders often underperform those

who trade less frequently. Instead, purchase investments you are willing to hold for the long term.

- **You don't consider income taxes when investing.** Ordinary income taxes on short-term capital gains and interest can go as high as 35%, while long-term capital gains and dividend income are taxed at rates not exceeding 10% (0% for taxpayers in the 10% or 15% tax bracket). Using strategies that defer income taxes for as long as possible can make a substantial difference in your portfolio's ultimate size. Some strategies to consider include utilizing tax-deferred investment vehicles, minimizing portfolio turnover, selling investments with losses to offset gains, and placing assets generating ordinary income or that you want to trade frequently in your tax-deferred accounts.

[Back to topics.](#)



Painful Lessons about Saving for Retirement

First, the stock market decline in 2000 removed substantial gains from individuals' net worths. Now, the decline in housing values has reduced people's net worths even more. For instance, the Center for Economic and Policy Research estimates that the average net worth of individuals between the ages of 45 and 54 is 25% less than it was in 2004, due to declining home prices. For individuals facing retirement in the near future, it has been a double whammy for their retirement savings. What lessons can be learned from these events?

- **Don't overload on hot investments.** By the time the average individual notices that a particular investment has become hot, it's often too late to take advantage of that knowledge. Many individuals invested in technology stocks just as they were peaking. Scared by stocks, many then started investing in homes and real estate. Instead of focusing on one hot area, make sure your investments are diversified among a variety of investments that you are comfortable holding.
- **Gains do not equal savings.** As stock and housing values went up in value, it caused a phenomenon called the "wealth effect." Because the increases in value made people feel wealthier, they felt less need for saving and more comfortable spending. While that fueled the economy for several years, it also meant that many individuals cut back on saving for retirement.

- **Excessive debt just makes things worse.** Whether it's a margin loan used to purchase stocks or a mortgage used to purchase a home, the dangers of too much debt become readily apparent once the value of the assets underlying those loans decreases. For many homeowners, it has become difficult to justify struggling to make a mortgage payment they can barely afford on a home that is decreasing in value.