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THIS ISSUE...

Estate Tax Follies

by John Slayton, JD/MBA, LLM-TAX, CFP®, AEP, CTFA

An unexpected consequence of Congress' recent pre-occupation with health care involves a lack of attention to the federal estate tax. The 2001 Tax Act gradually raised each individual's estate tax exemption and lowered the maximum estate tax rate from 2001 levels of $1 million exemption and 55%+ rate to $3.5.million exemption and 35% rate in 2009, repealed the estate tax totally for 2010 and is scheduled to return to the 2001 levels in 2011. This gradual reduction, repeal and return to 2001 rates was necessary in order to pass 2001 budgetary restrictions. In 2001, everyone agreed that Congress surely would amend the rules before the estate tax lapsed nine years later, on January 1, 2010. The House passed a provision last fall making the 2009 terms permanent. The Senate, pre-occupied over healthcare, failed to address the issue in time… and the estate tax lapsed on January 1 for the period of one year.

Before celebrating the demise of the estate tax, however, consider possible future scenarios:

>> Congress could enact transfer tax legislation retroactively to January 1 and either reinstate the 2009 terms or enact new ones [retroactive application would likely be challenged constitutionally].

>> Congress could enact transfer tax legislation as of the date of enactment, introduction or some other action, and either reinstate 2009 terms or enact new ones.

>> Congress could continue to do nothing and the 2001 terms and rates would return on January 1, 2011 *[certainly the worst possible result]*.

Further, when the estate tax disappeared on January 1, so did ***stepped-up basis*** for inherited property (with limited exceptions), replaced with the universally-loathed ***carry-over basis***. Now, even in a non-taxable estate, heirs will pay capital gains tax when they sell appreciated inherited low-basis property, rather than stepping the basis up to date-of-death values and avoiding tax on historical appreciation. This could be a significant tax increase to smaller estates and a windfall to the government (similar to alternative minimum tax).

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NOTABLE QUOTE

"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."
– Paul Samuelson

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What Lessons Have We Learned From TARP?

by Mike Palmer, CFP®

A little over a year ago a new acronym entered the lexicon – TARP, Troubled Asset Relief Program. Over the past many months we've witnessed a slow economic recovery, a booming stock market and an anemic housing situation. We believe having a historical perspective on markets makes us better advisors, so the plethora of publishing post-mortems analyzing the Great Recession have found an eager audience within our firm. We found Michael Lewis' *The Big Short* informative; Lewis highlights the danger in dismissing risk through complex financial models. Andrew Ross Sorkin's *Too Big to Fail* provided insight into the chambers of power on Wall Street, but seemed dogged by factual missteps. Hank Paulson's *On the Brink* provides the perspective of a key decision-maker most intimately involved in the hour by hour rescue efforts, but certainly has a personal bias. We've not yet read John Lowenstein's new book, *The End of Wall Street*, but have it on our list. Perspective will no doubt serve us well when it is different next time.

The original intent of TARP was to provide liquidity to the financial system and assist the nation's largest banks in strengthening their balance sheets. To that end, it appears to have succeeded. But as often happens with Congressional legislation, no good deed goes unpunished. Through March 31, 2010 the government has recouped $118 billion from firms that have fully exited the program. The *Wall Street Journal* reported the gain to taxpayers on this payback was about 8.5%. However, three of TARP's biggest recipients – AIG ($130 billion), Chrysler and GM ($80 billion combined) – are non-banks and the prospects of full government repayment from these entities is suspect at best.

In addition, government sponsored enterprises Freddie Mac and Fannie Mae have collectively received $130 billion and the Congressional Budget Office predicts the total of government assistance will approach $400 billion. It seems extremely doubtful much, if any, of this will ever be recouped. However, the Fannie and Freddie resuscitation operates outside of TARP, a fact lost on most Americans.

We'll leave the issue of the wisdom of TARP to pundits and historians. The key takeaways of the past 16 months for us as financial advisors are:

>> avoid investment complexity in favor of investment transparency

>> always remember risk and return are related

>> high impact, improbable events happen more frequently than we'd like to admit

>> liquidity is a more powerful psychological tool than it is an asset class

As advisors, during the span of a forty year career, we're likely to see severe downturns (albeit hopefully not on as grand a scale) perhaps six to eight times. Maintaining an historical perspective will provide a solid foundation during those times of tribulation.

Taxing Roth Conversions

by John Slayton, JD/MBA, LLM-TAX, CFP®, AEP, CTFA

We are all familiar with the removal of the $100,000 income limitation from traditional to Roth IRA conversions, effective January 1, and the special default option, for 2010 conversions only, to recognize the income and pay taxes ratably with our 2011 and 2012 federal tax returns. Clearly, the government is incentivizing us to convert huge sums of traditional tax-deferred IRAs into Roth IRAs, front-loading taxes that otherwise might not be due for years. If we believe that our personal current tax rates are comparable to where they will be in retirement, or that the value of our traditional IRA assets are so depressed that they are likely in future years to soar like a Phoenix from the ashes, we might decide to convert significant traditional IRA assets into Roth IRAs in 2010—but how should we handle the taxes due?

We immediately are confronted by two apparently conflicting time-tested tax mantras:

>> *It is always better to pay taxes later, rather than sooner;*

>> *It is always better to pay taxes at lower rates, rather than higher rates.*

The default rule for 2010 Roth conversions is to pay the tax ratably on your 2011 and 2012 returns, unless you opt on your 2010 return to recognize all the income and pay all the tax. With the Bush tax cuts expiring at the end of 2010 and exploding federal budget deficits, we can safely assume that income tax rates will be higher (perhaps significantly) in 2011 and 2012. So, unless we believe that our individual taxable income will be lower in 2011 and 2012 than in 2010, we might decide to "bite the bullet" and pay the tax in 2010, knowing that we have lost the available investment return from the taxes paid earlier than necessary. The good news is that we have until we file our 2010 return (October 15, 2011, if extended) to finally decide when to pay the tax and we should have a good idea what 2011 and 2012 income and tax rates will be by then.

What about estimated tax payments?

Estimates must be made quarterly (to avoid penalties/interest of 4% of the late payment for each quarter) if you will still owe $1,000 or more in taxes (after withholding credits, deductions, etc.) and you have not withheld 100%/110% (if income is over $150,000) of last year's total tax liability or 90% of this year's tax liability. Roth conversions in 2010 have two possible estimate approaches:

>> **Recognize income and pay tax ratably on 2011 and 2012 returns (the default rule)**

- No impact on 2010 estimates.
- In 2011 – pay protective estimates of at least 100%/110% of 2010 income and on April 15, 2012 pay tax on the 50% of the conversion amount recognized in 2011.
- In 2012 – pay higher estimates of at least 100%/110% of 2011 income (including 50% of the conversion). This should cover the tax for the 50% of the conversion amount taxable in 2012.
- In 2013 – either pay estimates of at least 100%/110% of 2012 income (higher due to the 50% of the conversion amount recognized in 2012) or aim for 90% of the estimated 2013 tax liability (with the risk that you under-estimate).

>> **Opt to recognize income and pay tax in 2010**

- In 2010 – pay protective estimates of at least 100%/110% of 2009 income and pay tax on the entire conversion amount on April 15, 2011.
- In 2011 – either pay estimates of at least 100%/110% of 2010 income (higher due to the entire conversion amount recognized in 2010) or aim for 90% of the estimated 2011 tax liability.

Remember that the fair market value of the converted assets on the date of a Roth conversion are included in your gross income ratably over the entire year. A $100,000 conversion in January 2010 is treated as $25,000 income per quarter, if you opt to pay the entire tax on your 2010 return. If you choose the default deferral provision, the converted amount is recognized as income ratably throughout 2011 and 2012 (one-eighth each quarter).

Finally, if at the end of any year you have underpaid estimates and face a penalty, simply increase withholdings from W-2 payrolls or from IRA withdrawals (which are treated as paid equally throughout the year) to make up any deficit from earlier quarters. ***Proper payment of taxes on a Roth IRA conversion need not involve predictive powers of Nostradamus or the Mayans, just a little planning.***

Why Hire A Financial Advisor?

Financial journalist Nick Murray attributes investor performance to two variables: investor behavior and asset allocation. Recent data seems to indicate the results are less than impressive when investors "fly solo."

The consulting firm Spectrem Group recently released their survey of 2009 401(k) retirement account allocations. According to the Spectrem report, 6% of retirement plan assets moved from equities to cash in late 2008, but only 1% had returned to equities by the end of 2009. "The big story for 401(k) investors is that if they stayed the course, they are now in good shape," said Dean Kohmann of Spectrem. Regrettably, it appears the majority failed to stay the course.

Mutual fund data from the Investment Company Institute (ICI) provides further evidence that Joe Investor suffers from a case of whipsaw psychosis. Through February, ICI reports 14 consecutive months of positive net inflows into bond mutual funds, totaling $428 billion. This during a time of historically low bond yields.

Over the same period, only $8 billion of funds flowed into equity funds. In fact, if it weren't for $16 billion that went into stock funds during January 2010 (after the S&P was up 26% in 2009), there would have been net *outflows* from equity funds.

We view this as just the latest example of why working with a capable financial advisor makes sense.

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The most commonly utilized estate tax reduction tool is the ***credit shelter (or bypass) trust***, designed to fully utilize each spouse's estate tax credit. An amount equal to the estate tax credit is placed into a bypass trust, allowing the surviving spouse to utilize the funds to live, but bypassing the amount around the surviving spouse's estate at time of death. Because there is currently no estate tax or credit, a spouse dying today with this provision would pass all sums directly to the surviving spouse, without funding any bypass trust. No tax is due on the asset transfer to a surviving spouse, but, because all funds wind up in the estate of the survivor, a much higher estate tax will likely be due at the death of the second spouse than with a properly funded bypass trust. Similarly, a provision funding a bequest to children of a first marriage, by reference to the estate tax credit, would receive no funding for the children and all would go to the current spouse.

Accordingly, attention is needed in the short term, lest an untimely demise before Congress acts to correct the current situation voids our carefully crafted estate plan. Based upon the ultimate wisdom of Congress, longer term modifications will be required later. ***Always remember that, at our death, our assets go in three directions: to our designated beneficiaries and charities or to the government.*** We must all stay on top of developments in the estate tax arena, because the default rule inevitably involves significant tax revenue to the government, rather than inheritance to our heirs or gifts to our charities.

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