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Cut Estate Tax After The Stock Market Plunge

Settling an estate is never easy or fun. But even as family members try to come to grips with their loss, there are crucial decisions to be made, particularly if the person who has died left behind significant wealth. To calculate whether there are estate taxes to be paid, federal authorities normally look at the value of the assets owned on the date of death, and that could be especially painful in these days of plunging real estate and stock values. If the worth of assets has plummeted since the death, the family could find itself paying taxes on wealth that no longer exists. But there is a way to avoid this unhappy result. By electing a special "alternate valuation date" for the estate, an executor may be able to slash the estate tax bill or even wipe it out completely.

In 2009, the estate tax exemption can effectively shelter up to $3.5 million of assets from federal estate tax. (That's up from $2 million for 2008.) Assets in excess of the maximum exemption are taxed at a top federal rate of 45%. The estate tax is scheduled to be repealed for 2010, but it will be revived the following year with an exemption of just $1 million. That odd situation is the result of compromises made when the massive Economic Growth and Tax Relief Reconciliation Act was passed in 2001. And though Congress could decide to change the law and perhaps permanently repeal the estate tax, most observers expect it to remain in place in some form, probably with something near the current exemption level and estate tax rates. That's an outcome President Barack Obama has said that he favors.

But what of the estate of someone who died in 2008? Only $2 million in assets would be exempt from federal taxation, with any additional amount taxed at a 45% rate. And if the death occurred before the stock market meltdown, though the value of the estate may have been cut significantly, any taxes would ordinarily be based on the estate's earlier value.

That's where the special tax election can help. Instead of using the date of death for the estate tax valuation, the estate's executor could choose an alternate date of six months after the date of death. This is an unusually old tax break, first established during the Great Depression, but it can serve as a particularly useful estate-planning tool today.

Consider this example. Suppose that Deborah's father, Richard, passed away on August 1, 2008. Richard's estate comprised mainly real estate, stocks, and bonds. Deborah is the sole beneficiary of the estate. On August 1, 2008—the date of Richard's death—the estate was worth $3 million. After the $2 million estate tax exemption was applied, Deborah would still have to pay federal tax on the remaining $1

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Changes In Time Bring Changes In Policy

There's no shortage of economic and geopolitical headlines to keep the casual observer wondering what and who to believe. This newsletter gives us another opportunity to address these topics head on and focus on what's most important.

Let's take RMDs, for example. In 2009, the minimum distribution that folks over 70½ are required to make from their retirement accounts is waived. This is great information for those who were paying taxes on income they didn't need. The RMD comes back in 2010, but let's enjoy it while it lasts!

Estate planning is another key area. With the federal estate exemption likely to revert to old levels, it's important to make sure that bypass and credit shelter trusts in particular remain compliant. If you created your trust before 2001, it may be time to visit the attorney again. And given many portfolios' significant losses, using an alternate valuation date may save thousands of dollars in estate taxes.

Other articles in this issue include ways to avoid becoming another identity theft statistic and some things to watch out for when rolling over your 401(k).

Finally, many investors saw their nest eggs drop 30% to 50% last year, but our clients didn't. We encourage you to spread the word to any friends and family where appropriate; introductions are always appreciated.

Happy Summer!

Jim Joseph, CFP®
Vice President

Federal Estate Tax Exemption... Going Up!

At long last, we're approaching the final step of a long climb for the federal estate tax exemption—the value of assets in an individual's estate that is shielded from potential estate tax liability. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the exemption amount (also known as the Applicable Exclusion Amount) gradually increased to $2 million for 2008, and has finally jumped to $3.5 million for 2009.

As the exemption has risen, the top tax rate for estates has declined to 45% in 2009, and under EGTRRA, the federal estate tax is scheduled to be repealed completely for 2010, only to return at pre-EGTRRA levels in 2011. While that still might happen, there's a growing consensus for congressional compromise that would keep the estate tax but with a high exemption level—perhaps 2009's $3.5 million.

With these changes afoot, it makes sense to take a fresh look at immediate and long-range estate plans. At a minimum, you should consider the implications of the higher estate tax exemption amount for 2009.

Prior to EGTRRA, the federal estate tax exemption for 2001 was only $675,000. But EGTRRA raised the exemption to $1 million for 2002 and started scaling back the highest tax rate from 55%.

If the estate tax makes its scheduled exit in 2010, which many believe is unlikely, another change will complicate tax planning. Under current law, people who inherit assets are allowed to "step up" the assets' cost basis to their market value at the owner's death. That step-up is supposed to go away in 2010, with heirs instead inheriting the original cost basis. That could increase capital gains tax liability when the assets are sold, and could force heirs to have to go through years of old documents to determine their basis. But there will be two key exceptions—a one-time $1.3 million step-up in basis, and an additional $3 million step-up for assets inherited from a spouse.

Estate Tax Exemption In Flux

Tax Year	Estate Tax Exemption ($)	Maximum Tax Rate (%)
2009	3.5 Million	45
2010	Unlimited	0
2011	1 Million	55

While much about the future of the estate tax remains up in the air, it's important to have your will and trust documents revised to reflect the 2009 change to a $3.5 million exemption. Wealthy couples may also want to keep up to $3.5 million in assets in each spouse's name to make the most of the estate tax exclusion. A credit shelter trust, for example, may use the maximum exemption to establish how much goes into the trust when the first spouse dies. But using the new, higher amount could shortchange the surviving spouse unless special provisions are made.

One strategy the new exemption level doesn't affect is your ability to reduce your taxable estate through lifetime gifts. The annual gift tax exclusion increased in 2009, to $13,000 per recipient from $12,000 per recipient in 2008.

We can work with you and your estate planning attorney to determine whether your estate plan should be revised to factor these and other possible changes in estate laws. ●

New Law Suspends RMDs For Just One Year

There's good news and bad news for retirees in the new pension law—the Worker, Retiree and Employer Recovery Act of 2008. The good news is that you don't have to take the usual "required minimum distribution" (RMD) from tax-qualified plans and IRAs. The bad news: The RMD exemption applies only for the 2009 tax year. The normal rule wasn't suspended for 2008—when you probably needed it most.

If you own assets in a tax-qualified plan such as a 401(k), an IRA, or both, you ordinarily must begin taking RMDs by April 1 of the year following the year in which you turn age 70½. For instance, if your 70th birthday was January 1, 2008, you became 70½ on July 1 of that year, so you must take your first distribution by April 1, 2009. That's actually the distribution for the previous year, and you have to take a second by the end of 2009. However, if you are still working and you don't own five percent or more of the company that employs you, you may postpone distributions from qualified plans—but not from IRAs—until you actually retire.

The amount of the annual RMD is based on your life expectancy and the balance in your account on the last day of the prior year. Unfortunately, that means that RMDs for 2008 must reflect the account balance on December 31, 2007, even though that's probably much more than the account is worth now, after the late-2008 stock market plunge.

Some retirees were hoping Congress would provide last-minute relief for 2008 RMDs. But the technical hurdles proved too daunting, as most retirees had already received their annual distributions before the law was

Avoid Becoming A Victim Of Identity Theft

How bad is the identity theft crisis? In recent studies by Gartner Research and Harris Interactive, seven million people said they'd been victimized. That's more than 19,000 a day, almost 800 per hour, and 13 every minute. And according to the Identity Theft Resource Center, the average identity theft victim spends 600 hours, $16,000 in lost wages, and $1,400 in out-of-pocket expenses trying to repair the damage.

Though there are ways to limit the harm if someone steals your personal information, prevention beats any cure. Here's how to reduce your vulnerability.

Don't give out personal information. Unless you know the person you're dealing with, limit the information you provide. If you get a call from a telemarketer or even a government agency, ask for a customer service number and check whether the caller is legitimate. If you are still in doubt, contact your Better Business Bureau. If it's a company you've dealt with before, make sure the caller's information matches what's written on past correspondence.

Guard your mail. Identity thieves may sort through trash or raid your mailbox to find bank numbers and other personal information. To protect yourself, shred discarded mail. If you're going to be away, ask the Postal Service (800-275-8777) to hold your mail until you return. And don't leave outgoing mail in your mailbox; use a secure collection box or take it to the Post Office.

Keep track of credit card receipts. Though most merchants limit the amount of personal information printed on receipts, they're still valuable to identity thieves. So ask store clerks to hand you your receipt rather than sticking it into a bag, where it's more likely to be misplaced.

Know what you have in your wallet. Keep an inventory of the credit cards you carry and make sure you have the numbers written in a safe place. Leave your Social Security card safely at home, and be very careful with health insurance cards, which may also list your Social Security number—the holy grail for identity thieves.

Clear your hard drive before you dispose of your computer. Make sure all personal information is non-retrievable before you give away an old computer. If in doubt, remove the hard drive and have it destroyed.

Lock up your personal items. At work or the gym, always secure your wallet or purse in a locked drawer or locker. Left unattended for even a minute, these items could give an alert thief all that's needed to make you the next victim.

Routinely check your credit bureau report. If an identity thief uses your credit card number, the transaction should show up on your credit report. So, at least once a year, request a report from each of the three credit reporting agencies: Equifax (800-525-6285 or www.equifax.com); Experian (888-397-3742) or www.experian.com); and TransUnion (800-680-7289) or www.transunion.com). Reviewing these reports regularly could help you catch a thief before the damage is too great.

Review all bank and credit card statements. Before you pay your bills and file your statements, check carefully to make sure you recognize all the charges. If you find a discrepancy, report it to your credit card company or bank right away. In most cases, they will work on your behalf to help resolve the problem.

Follow Internet safety rules. Your computer and your online transactions are great sources of information for identity thieves. These measures can limit your vulnerability.

- Purchase virus protection and "ad ware" software. Some viruses can send out information from your computer to a perpetrator.
- Don't download files from unknown sources. You might be opening up a window of opportunity for a thief to browse your computer.
- Use a firewall to block unknown Internet sites from getting access to your files. This may be especially important if your computer is always connected to the Internet.
- If others have easy access to your computer, avoid automatic log-on features that could enable an unauthorized user to exploit your personal information. Use password options that limit accessibility to personal files, especially those that hold financial information. And avoid passwords that are easy to guess—your mother's maiden name, for example.

Make sure any Internet purchases or financial downloads happen via a secure server. And always take the time to review vendor privacy policies to check whether personal information could be sold or distributed to other parties. ●

signed. Moreover, the IRS has indicated it won't change the rules retroactively. To compensate for being stuck with disproportionately large distributions for 2008, try investing your distributions in stocks in a taxable account and reap the rewards when the market rebounds.

At least the new law suspends the requirement for the 2009 tax year. If you can afford to leave your retirement nest egg untouched this year, you may be able to recoup some of the value you lost during the stock market downturn. With this temporary reprieve, you could stockpile more cash if the market rebounds.

But first-timers who turned age 70½ in 2008 aren't off the hook. Your first distribution, due by April 1, 2009, is actually for 2008, and you'll still have to take it this year. But you won't have to make a withdrawal for 2009. If you're turning age 70½ in 2009, you'd ordinarily have to take an RMD by April 1, 2010—a withdrawal the new law permits you to skip. But you'll still have to take a distribution for the 2010 tax year by December 31, 2010.

Keep in mind that not taking the RMD (other than in 2009 when you don't need to) is unwise. The penalty tax for failing to take an RMD is 50% of the amount of the required distribution you didn't take. ●

Avoiding The IRA Rollover Crackdown

To avoid current tax and penalties on money transferred to an IRA from a 401(k) or other tax-qualified retirement plan, you must complete a rollover within 60 days. During the past few years, the IRS has granted waivers to that rule when extenuating circumstances delayed the transfer. But new tax rulings appear to reduce your chances of special dispensation.

Normally, a distribution from a tax-qualified, employer-sponsored retirement plan such as a 401(k) or 403(b) is considered income, taxable at ordinary income rates. Moreover, if you're not yet age 59½, you'll be assessed a 10% penalty on the distribution, unless a special exception applies. And finally, your employer will withhold 20% of the distribution and send the money to the IRS to help pay taxes you may owe.

You can sidestep all or most of those issues by transferring the funds to a traditional IRA within 60 days. You have two choices for doing this.

The preferred method is via a "trustee-to-trustee" transfer, where you arrange for your employer to transfer your existing retirement plan to a new rollover IRA that you've opened. Since you never touch the funds, it avoids the 20% tax withholding and the possibility of missing the 60-day deadline.

If you take a check from your employer and deposit the full amount of the distribution in an IRA within that 60-day window, you'll avoid a penalty, but your employer will still withhold that 20%. While you'll get that back when you file your taxes, you have to come up with the cash before then in order to deposit, as required, the full amount of the plan's pre-transfer value into your new IRA.

A 2002 tax law change allows the IRS to grant a waiver if you have a good reason for missing that 60-day deadline. If you can show the delay was the fault of the financial institution receiving the funds, for example, you're off the hook. But in less clear-cut cases, the IRS will decide based on the circumstances. And after being lenient about waivers for several years, the agency appears to have adopted a tougher stance. That's clear in two recent private rulings.

In the first, a widower received his deceased wife's interest in a 403(b) plan. After the plan administrator withheld tax, the husband failed to deposit the balance in an IRA within 60 days. He wrongly believed the withholding absolved his tax liability. The IRS turned down his request for a waiver.

The second ruling involved a retired IRA owner who wanted to transfer funds to an IRA with a provider closer to his new home. But the funds instead went to a non-IRA account, and the account owner failed to move the money into another IRA in time. Again, the IRS nixed the waiver request.

These rulings underscore the need for careful handling of retirement plan transfers. Please give us a call before you make any moves. ●

Cut Estate Tax

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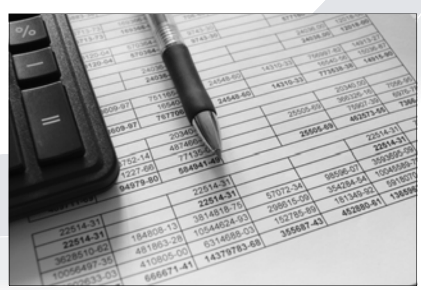
million in the estate. At the 45% tax rate, the tax bill would come to a hefty $450,000.

However, Richard's executor can elect to use the alternate valuation date instead. Suppose that the estate has lost 35% of its value and, six months after Richard's death—on February 1, 2009—it's worth only $1.95 million. That's below the $2 million exemption for 2008 (which still applies, because that's when he died). So there's no estate tax liability and Deborah's inheritance is worth $450,000 more than it would have been with the earlier valuation date.

This is an all-or-nothing proposition—you can't select some assets to be valued on the alternate valuation date and some to use the actual date of death, even though some property may be worth more on the later date. You'll need to consider the value of the full estate on the two dates and choose the one that's more beneficial.



Moreover, if you choose the later valuation date and some assets have been distributed before then, they'll be valued based on the date they were handed out. So it could make sense for the executor to distribute property that is appreciating in value and hold on to assets that are losing value.

You can use the alternate valuation election only if this tax break decreases the gross estate and the resulting estate tax bill. It can't be used, regardless of the estate's value, if all assets are to pass to a surviving spouse—and thus qualify for the unlimited marital exemption—or if the estate tax liability on the original date of death would be zero.

If you've recently inherited significant assets, we can work with you and your attorney to determine whether this election would reduce estate taxes and increase the value of your inheritance. ●

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